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THESIS

A DOD CONUNDRUM:
THE HANDLING OF FEDERAL RETAIL EXCISE TAX
ON THE ARMY'S MEDIUM & HEAVY TRUCK FLEET

by

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June 2001

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This thesis explores the genesis of a Federal excise tax known as, FEDERAL RETAIL EXCISE TAX (FRET), and its impact on the acquisition of Medium & Heavy Tactical Wheeled Vehicles by the US Army and its sister Services. The thesis examines how DOD is impacted by the payment of this tax to the Department of the Treasury, through the IRS, and it reviews and discusses the direct cost, lost opportunity costs, and administrative burden to both DOD and its wheeled vehicle manufacturers. DOD payment of FRET to its contractors is in actuality the payment by one Government agency, the Army, to another Government agency, the IRS, through a third party, the defense contractor; who is considered by the IRS to be the taxpayer of record. As a result of this "three party" arrangement, no feedback mechanism exists between the Army and the IRS to verify actual payments, or for the Army to discuss and mitigate tax issues directly with the IRS. This situation is examined by addressing the primary research question: "What is the cost to the Government, both monetary and otherwise, of the Army paying FRET to the IRS, through third party defense contractors?

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A DOD CONUNDRUM: THE HANDLING OF FEDERAL RETAIL EXCISE TAX ON THE ARMY'S MEDIUM & HEAVY TRUCK FLEET

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ABSTRACT

This thesis explores the genesis of a Federal excise tax known as, FEDERAL RETAIL EXCISE TAX (FRET), and its impact on the acquisition of Medium & Heavy Tactical Wheeled Vehicles by the US Army and its sister Services. The thesis examines how DOD is impacted by the payment of this tax to the Department of the Treasury, through the IRS, and it reviews and discusses the direct cost, lost opportunity costs, and administrative burden to both DOD and its wheeled vehicle manufacturers. DOD payment of FRET to its contractors is in actuality the payment by one Government agency, the Army, to another Government agency, the IRS, through a third party, the defense contractor; who is considered by the IRS to be the taxpayer of record. As a result of this "three party" arrangement, no feedback mechanism exists between the Army and the IRS to verify actual payments, or for the Army to discuss and mitigate tax issues directly with the IRS. The result has been numerous tax disputes between the Army, its contractors, and the IRS, resulting in at least three different opinions between the IRS, the General Accounting Office (GAO), and the Armed Services Board of Contract Appeals (ASBCA) for the proper handling of FRET in sealed bid acquisitions. This adds complexity to tax applicable acquisitions, and may allow defense contractors to manipulate the competitive acquisition process. This situation costs DOD millions of dollars each year, and is examined by addressing the primary research question: "What is the cost to the Government, both monetary and otherwise, of the Army paying FRET to the IRS, through third party defense contractors?

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I. INTRODUCTION

A. PURPOSE

The US Army Tank-automotive and Armaments Command (TACOM) is the proponent for the acquisition and sustainment of all tactical wheeled vehicles within the Department of Defense (DOD). As such, it is responsible for acquiring these assets for the Army, other US Military Services, and foreign military sales (FMS) customers. This thesis examines how, in the course of acquiring these much needed military assets, TACOM is required to pay its contractors additional money in the form of a tax entitled, Federal Retail Excise Tax (FRET), that is ultimately paid to the Department of the Treasury, via the Internal Revenue Service (IRS).

In the course of this examination, this thesis explores the genesis of this particular tax arrangement and the impact it has on the DOD and Treasury Department budgeting process. In addition, it reviews and discusses the cost and administrative burden of implementing this particular tax arrangement from both the Government and private sector perspectives. This thesis also evaluates the current method of payment of FRET by DOD components, and whether this is an efficient manner for the Treasury Department to collect these monies for the Federal Highway Trust Fund. Furthermore, it looks at the cost to administer these tax payments on behalf of these DOD components, and their defense contractors. It also examines the FRET statute itself in an effort to understand the legal and political ramifications of potential changes to the current method of collection.

Additionally, this thesis looks at the benefit to society of having an extensive and well maintained intra-continental highway system, as impacted by the amount DOD pays into the Federal Highway Trust Fund through its contractors, versus the amount of time spent by DOD Medium and Heavy Tactical Wheeled Vehicles on the nation's highways, and the cost to DOD of administering the payment of this tax by its contractors. During the course of this review, the thesis also explores how TACOM acquires its vehicles, and whether this contributes to the impact of FRET on the DOD budget process.

B. BACKGROUND

The United States (US) has approximately 40 million trucks and spends about $110 billion yearly to transport goods by truck. [Ref. 17] The US Department of Transportation's "Pocket Guide to Transportation" contains published statistics for 1998 that indicates there were 1,741,854 combination trucks in the US, which traveled a total of 118,800,000,000 miles for an average of 68,203 miles per vehicle. To allow for the efficient transportation of commercial goods throughout the country via the trucking industry, the US has an extensive network of national highways. As the nation's transportation system grew and the Federal highway system expanded, the Federal Government eventually imposed Federal Excise Taxes, as a way to support the Federal Highway Trust Fund, which was set up to expand and maintain the Federal highway system. This resulted in the imposition of a Federal Excise tax on Heavy Trucks beginning in 1971, and led to the current retail sales tax on trucks, which was established in 1983 as the Federal Retail Excise Tax (FRET).

In the case of DOD, its contractors are required to pay this tax on all Medium and

Heavy Trucks weighing over 33,000 pounds Gross Vehicle Weight (GVW) and all Medium and Heavy Trailers and Semitrailers weighing over 26,000 pounds GVW. The result is that the DOD payment of FRET to its contractors is in actuality the payment by one Government agency, the Army, to another Government agency, the IRS, through a third party, the defense contractor; who is considered by the IRS to be the legitimate taxpayer. As a result of this "three party" arrangement, no feedback mechanism exists between the Army and the IRS to verify actual payments, or for the Army to discuss and mitigate tax issues with the IRS. The result has been numerous tax disputes between the Army and its contractors that have resulted in at least three different opinions between the IRS, General Accounting Office (GAO), and the Armed Services Board of Contract Appeals (ASBCA) for the proper handling of FRET in sealed bid acquisitions. [Ref. 39] This adds complexity to tax applicable acquisitions, and may allow defense contractors to manipulate the competitive acquisition process. By anticipating potential changes in the FRET statute during the course of a particular system acquisition or making assumptions about the law that may or may not coincide with the DOD interpretation, contractors make differing interpretations of the tax statute in the course of preparing their bids on Army Tactical Wheeled Vehicle solicitations. From the perspective of a defense contractor, it is fully liable to the IRS if it fails to act in accordance with the law. Thus, it relies fully on its legal interpretation of its responsibilities, with the assistance of its corporate counsel, and the issue of procurement integrity in this regard is moot.

Despite the fact that both DOD and its contractors are relying on the FRET law as written, misunderstandings occur on a regular basis. One of the reasons this occurs is

because the FRET statute is known as a "sunset law," in that it expires approximately every five years unless reinstated by the Congress. The current statute expires in October 2001. [Ref. 52] In this era of multiyear contracting, defense contractors, either wittingly or unwittingly, may serve to undermine the Government procurement process by using FRET as a factor in their bid strategies. This can occur when contractors disguise the amount of tax included in the bid price for a particular vehicle. The result is that in a competitive situation the winning contractor could, in the worst case, change the outcome of a particular competition, or, at best, surreptitiously increase its profit margin, depending on Government actions taken after award. These Government actions could be as extensive as revisions to the tax code (e.g., reinstating the FRET statute every five years), to as mundane as a DOD component deciding to ship a vehicle, or group of vehicles, outside the continental US (OCONUS) instead of within the continental US (CONUS), in which case the tax would not apply. [Ref. 31]

This process in and of itself may not be any more inefficient than similar oligopolistic markets. After all, in a competitive environment where there is only one buyer, as long as the overall best value offeror wins, the Government still receives the most efficient outcome the marketplace can offer. However, the process may distort the source selection process and unduly influence price to the exclusion of other factors, thereby subverting the best value precept. Furthermore, inevitable post contract award actions by the Government (both DOD and Congress) result in true inefficiencies that are unique to the application of FRET within the DOD acquisition process. In addition, both the Government agencies involved and the contractor are required to maintain extensive

records and spend immeasurable time interpreting and ultimately negotiating the actual amount of FRET owed to the Government in any given circumstance. The cost of this record keeping and tax code interpretation process between DOD contractors, the Army, and the IRS may be compounded by the two Government agencies involved, the Treasury Department and DOD, who are unable or unwilling to communicate directly with each other on the matter. The result has been numerous tax disputes between the parties, which have cost the Army, Justice Department, IRS, and defense contractors thousands of man-hours to investigate, appeal, file motions, and reach settlements on FRET issues.

C. RESEARCH QUESTIONS

The following primary research question is addressed in this study: What is the cost to the Government, both monetary and otherwise, of the Army (Department of Defense) paying Federal Retail Excise Tax (FRET) to the IRS (Department of Treasury), through third party defense contractors?

Subsidiary Research Questions include:

(1) What is FRET and what is the Army policy regarding payment of FRET to its defense contractors?

(2) How do defense contractors administer the payment of FRET to the IRS?

(3) How does the FRET statute determine the manner of tax payment, and to what extent does this cause an administrative burden to the Army, the defense contractor, or both?

(4) To what extent should the Army change its policy regarding FRET?

(5) Should the FRET statute apply to DOD customers, and is there a more

efficient manner of determining the amount of the tax burden, and ultimately collecting this tax?

(6) What actions should be taken regarding statutory and regulatory language to modify the application of FRET?

D. SCOPE OF THESIS

The principal thrust of the research is to analyze the statute on FRET, and the current DOD policy on payment of FRET by its contractors. The intent of this review is to assess the impact of the law, and its implementation, on the Defense Systems Acquisition Management Process. Specifically, this examination will cover the DOD method of implementation, numerous attempts by the Army and DOD to change the FRET statute as it pertains to DOD, the reasons why the Army's attempts have been unsuccessful, and whether both DOD and the Congress should reconsider this issue. This study also considers recommendations on whether policy or statute changes are necessary to reduce any perceived inefficiencies within the current policy on the payment of FRET by defense contractors.

E. METHODOLOGY

Research for this thesis included a review of the Army's policy on the handling of FRET in its solicitations and contracts, and a review of how the policy has been revised and refined over the last twenty years, as a result of changes in the statute and litigation with defense contractors. Information was gathered by reviewing actual contracts, Requests for Equitable Adjustment (REAs), and various contractor claims that were filed with the ASBCA, including the judicial findings and rulings by the ASBCA in those

specific cases brought before it.

In addition, data were obtained directly from those DOD contractors involved in the payment of FRET in their contracts, by surveying these contractors in order to obtain written information concerning the impact of FRET on the administration of their DOD contracts. This included obtaining supporting data from law firms hired by the contractors to administer and litigate FRET issues with both the Army and the IRS.

A review of the actual FRET statutes, and the legislative intent behind them, was also conducted in an effort to frame the purpose and intent of the law. In addition, opinions of tax experts within the Department of the Army were reviewed and analyzed. As a former Procuring Contracting Officer (PCO), with experience in this subject matter, the researcher reviewed material and decisions made during the course of awarding and administering DOD contracts over a twenty year period, in an effort to assess the cause and impact of decisions made in the "heat of the battle," to determine if the implementation of FRET policy is consistent with the intent of the DOD policy-makers.

During the course of obtaining data from both Government and contractor contracting and legal personnel, subject matter experts were interviewed to determine their perspective on the imposition of FRET, and the manner in which it is collected. By asking questions concerning the type and number of people involved in the administration of FRET, conclusions were drawn as to the cost of collection ultimately borne by the taxpayer, and whether this is significantly different from the cost of collecting other Federal taxes from both the private and corporate sector.

F. ORGANIZATION

This thesis is organized into six chapters. Chapter II discusses the FRET statute and its history. It also concentrates on the DOD guidance for including contract clauses for Sealed Bidding and Requests for Proposal (Competitive and Noncompetitive) to implement the statute, as well as the FRET payment process from the Army and Major Subordinate Command (MSC) perspective.

Chapter III identifies and discusses problems that have occurred with the payment of FRET from both the Government and defense contractor perspective. It will also provide a summary of some of the more important litigation that has transpired over the last twenty years in an effort to provide a framework for discussing FRET payment issues.

Chapter IV provides details on the "true" cost of FRET to both the Army and its contractors. It includes a discussion on the cost of administering the tax from the Army, the contractor, and the taxpayer perspective.

Chapter V gives an analysis of the overall implementation cost of FRET. It uses information from Chapter IV to address questions as to the effectiveness and efficiency of the FRET payment process. It also addresses aspects of the statute that may cause an observer to question whether DOD should legally be required to pay FRET, and whether political issues more than legal issues are the cause of the current situation.

Chapter VI presents conclusions and recommendations. In doing so, it addresses issues that should be reviewed at the highest levels of Government to assess the need for further study to ascertain whether changes in the FRET statute or its implementation by DOD would make the current process more efficient and cost effective.

G. BENEFITS OF STUDY

This study addresses a long neglected area of Federal tax law that has a direct impact on DOD funding by Congress. In this era of downsizing and continuing funding reductions for DOD, it is imperative that the Federal Government, as a whole, and the DOD specifically, operate in the most efficient manner possible, while at the same time assuring our soldiers get the best equipment possible. The current tax laws concerning FRET may be an inefficient and ineffective way of collecting this tax. If true, the resultant tax and administrative burden being placed upon DOD is no longer acceptable to an organization that is in the middle of the largest acquisition reform movement ever attempted, in an effort to spend its limited funds wisely in defense of a nation at peace. If, as a result of this study, it is determined that either the tax should not be levied against defense contractors, or there is a more effective way of implementing said tax, the resultant savings to DOD would have a direct impact on the ability of DOD Services and components to provide for the nation's defense.

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II. FEDERAL RETAIL EXCISE TAX STATUTE AND ARMY IMPLEMENTATION

A. THE STATUTE

John E. Klecha writes in a White Paper he prepared for DOD review in 1993: [Ref. 39]

> The taxation of "vehicles" has been around since at least 1794, when the 3rd Congress levied duty upon "Carriages for conveyance of Persons." Excise taxes had their genesis with the 65th Congress (sic) which, in 1917, enacted a series of "War Excise Taxes." It was not until 1944 that the Government began taxing applicable goods and services sold to it through a Federal Excise Tax. This legislative change was requested by President Roosevelt because the time and expense consumed in satisfying the administrative requirements for exemption had become more burdensome than paying the tax. Prior to this time, the U.S. Government was generally exempt from Federal Excise Taxes. In recent times, Congress has imposed vehicle excise taxes at various times and rates. A Federal Excise Tax has existed on heavy trucks continuously since 1971 through repeated extensions. The only substantive change in the tax during that time was an increase in the tax rate from 10% to 12% to coincide with the change of the tax from a "manufacturer's tax" to a "retail sales tax" in 1983. The statute has generally been imposed for 5 (sic) year periods to parallel the 5 (sic) year spending plans for the Federal Highway Trust Fund for which these taxes provide support.

On April 2, 1987, Congress enacted the Surface Transportation and Uniform Relocation Assistance Act of 1987 (the 'Act'). [Ref. 39, 57] The Act amended Title 26, Section 4052 of the Internal Revenue Code relating to the excise tax levied on heavy vehicles, to add a subsection that required the payment of a "presumed markup" for the purpose of imposing the tax based upon retail, as opposed to a wholesale, or otherwise discounted price. [Ref. 57] The resultant regulation provided that, with certain exceptions, the presumed markup percentage would be four percent. The exceptions to this additional tax were, "trailers, semitrailers, and remanufactured automobile truck

chassis and bodies and tractors." Despite a review by the Army into the legislative intent that made it clear that the proposed legislation was not intended to apply to the Army purchase of military vehicles acquired through competitive procedures directly from vehicle manufacturers in an "arms length" manner, the IRS assessed this additional tax on defense contractors providing applicable vehicles to DOD. [Ref. 37] Although subsequently overturned in 1997, as the result of a lawsuit brought by Oshkosh Truck Corporation on behalf of the US Army, the statute applied to the purchase of Medium and Heavy Tactical Wheeled Vehicles for the 10-year period from 1987 to 1997. [Ref. 58]

Today, the legislation is represented in the United States Code as Title 26, Section 4051, entitled, "Imposition of Tax on Heavy Trucks and Trailers Sold at Retail." It imposes a 12 percent tax on the first retail sale of truck chassis and bodies exceeding 33,000 pounds gross vehicle weight (GVW) and truck trailer and semitrailer chassis and bodies exceeding 26,000 pounds GVW. [Ref. 52] Because much of the Army's Medium and Heavy Tactical Wheeled Vehicle fleet meets the description of vehicles, as stated in the statute; said tax applies to the US Army purchase of Medium and Heavy Trucks, Trailers, and Semitrailers that exceed these GVWs.

B. DEPARTMENT OF DEFENSE APPLICATION AND GUIDANCE

Vehicle systems that are covered by the above description and are subject to FRET include: (1) Five Ton Truck systems such as the M939 Series of vehicles, produced by AM General Corporation from 1981 through 1986, and by BMY Corporation from 1986 through 1991; (2) the M939 Series successor, the Family of Medium Tactical Vehicles (FMTV) produced by Stewart & Stevenson Services, Inc. from 1992 to the present; (3) the Heavy Expanded Mobility Tactical Truck (HEMTT)

system and the Heavy Equipment Transporter (HET) tractor, produced by Oshkosh Truck Corporation from 1983 to the present; (4) the M915/M916 Line haulers, produced by AM General in the early 1980s and now by Freightliner Corporation from 1989 to the present; and (5) numerous other trailer configurations, heavy commercial truck configurations, tankers, and utility trucks that exceed statutory weight requirements. From 1981 to the present, DOD has spent many billions of dollars on these tactical vehicle systems that has resulted in the payment of hundreds of millions of dollars in FRET. During this timeframe, the Army, through DOD, has made several attempts to gain relief from this tax, both through the executive branch, by proposing Secretary of the Treasury exemption of Military vehicles, and legislatively via DOD annual requests to Congress for acquisition process changes. An example of the TACOM effort expended on this topic took place in 1988, under an early Legislative initiative to generate acquisition reform. It was called the *Pilot Contracting Activities Program (PCAP)*. [Ref. 41] In this particular case, however, the initiative to revise legislation to exempt Federal Excise Tax from purchases by the Armed Forces was disapproved by "higher headquarters," as being outside the jurisdiction of PCAP, because it involved the Department of Treasury, as well as DOD. [Ref. 36] Here, as in other cases regarding FRET over the last 20 years, organizations within DOD decided not to pursue this issue further, due to higher priority issues. [Ref. 32]

DOD and subsequent Army implementation of the tax on these vehicle systems is governed by the Federal Acquisition Regulation (FAR). Specifically, the FAR requires the inclusion of provision 52.229-3, "Federal, State, and Local Taxes," for competitive, fixed-price contracts, or 52.229-4, "Federal, State, and Local Taxes (Noncompetitive

Contract)," for fixed-price noncompetitive contracts, that exceed the simplified acquisition threshold, and when work is to be performed wholly or partly within the United States, its possessions, or Puerto Rico. [Ref. 21, 22] Except for minor differences related to the method of procurement (competitive versus noncompetitive) the use of either clause requires that unless otherwise provided in the contract, the contract prices include all applicable Federal, State, and local taxes and duties. Both clauses also allow for the increase or decrease in the contract prices for any "after-imposed" or "after relieved" Federal tax. [Ref. 23, 24]

C. ARMY AND MAJOR SUBORDINATE COMMAND PERSPECTIVE

The FAR clauses cited above are supplemented in all TACOM contracts with two additional Command level clauses. The first clause entitled, "Federal Retailers Excise Tax Adjustments," requires the contractor to identify in its prices, the total dollar amount included in the unit price that represents its FRET liability. [Ref. 45] The second clause entitled, "Contractor Representation of Basis for Adjustment in Contract Price due to Change in Federal Retailers Excise Tax Liability after Contract Award," prescribes procedures for contractor representations of net FRET adjustments as a result of after-imposed or after-relieved Federal tax, as defined in the Federal, State, and Local Taxes clause of the contract. [Ref. 46]

The Army felt it necessary to provide this supplemental guidance to its contractors for several reasons. These reasons involved tax calculation interpretation issues that required negotiation and resolution, as a result of after award actions on the part of the Army and its contractors. One cause of these continuing interpretation issues was the impact of several related statutes that required certain vehicle components to be

calculated separately, and at a different rate than the rest of the vehicle. [Ref. 39] For example, the tax code provides guidance on how to calculate FRET for tires separately from other vehicle components. [Ref. 54] Thus, to calculate vehicle FRET correctly a manufacturer must separate out the cost of the tires, calculate the cost of the vehicle (less tires) for FRET purposes, separately calculate the tire FRET, and then add the tire FRET to the vehicle FRET to obtain a total FRET figure. Although it is solely the contractor's responsibility to make the correct interpretation of the tax code prior to contract award in accordance with the Federal, State, and Local Taxes provisions of the solicitation, it quickly becomes a mutual problem after contract award, when design, vehicle destination (CONUS versus OCONUS), quantity, production rate, or other changes require the re-negotiation of contract prices. Unfortunately, this happens all too often between the DOD and its contractors.

As a result of these ongoing FRET issues, TACOM, in an effort to further define and simplify the FRET payment process on the Army's most recent contract for five-ton trucks, the Family of Medium Tactical Vehicles (FMTV), took the additional step of including a cost-reimbursable Contract Line Item Number (CLIN) within its fixed-price contract, specifically for the payment of FRET by the contractor. Due to disagreements on prior contracts over the amount of FRET paid by the contractor to the IRS, the Army determined that the best way to assure that it only paid the contractor the amount of tax it actually paid to the IRS was to separate FRET from the fixed-price vehicle CLINs, and force the contractor to provide proof of payment to the IRS before payment under the cost-reimbursable CLIN would be incorporated into the contract. [Ref. 12] Although the jury is still out on this latest attempt to simplify the process and assure the Army is

paying the contractor only the tax it pays the IRS, indications are that this, too, is fraught with questions of fairness and timely payment issues from both the Government and contractor perspective.

These supplemental clauses have been generated and evolved over time as a result of numerous issues with the implementation of the FAR tax clauses that have resulted in contractor REAs, certified claims, and Government counter claims. [Ref. 1, 4, 7, 9, 10, 11] These issues occur due to some action on the part of the Government, whether it was the executive or legislative branch, which resulted in either an after-imposed or after-relieved tax change. The final result is that TACOM provides very specific guidance to its contractors, as to the methodology to be followed should there be a change in FRET requirements under its contracts. [Ref. 12]

The implementation of these supplemental clauses, as indicated above, were the result of issues between the Army and its contractors over after-award changes to its contracts that impacted the payment of FRET from 1981 to the present. [Ref. 1, 4, 7, 9, 10, 11] Prior to the early 1980s, Federal Excise Tax (the precursor to the current FRET statute) issues were not as prevalent for several reasons. First, the Army, in its downsizing mode after the Vietnam war, was not procuring a significant amount of materiel, including Medium and Heavy Tactical Wheeled Vehicles, from the period of 1971, when the Federal Excise Tax (FET) on "heavy trucks" was implemented, through 1981. [Ref. 27] Second, the use of multiyear contracting methods for tactical vehicles was also not prevalent during this timeframe. Thus, the issue of contracting for Tactical Wheeled Vehicles over a five year period under a single contract that did not necessarily correspond to the expiration of the actual FRET statute in its five year "sunset" cycle did

not exist. Not until the Army and the other Military Services began replenishing their outdated Medium and Heavy Tactical Wheeled fleets, in the early 1980s, did the real impact of FRET, and the manner in which it was paid, become evident. [Ref. 1, 4, 7, 9, 10, 11]

Up until the 1980s, the standard FAR Tax clauses, which required defense contractors to include the tax in their vehicle prices when bidding on Government contracts, were presumed adequate. However, once the Army began buying relatively large quantities of vehicles under long-term contracts, a myriad of FRET issues became readily apparent, as defense contractors in conjunction with their DOD agency counterparts wrestled with the ramifications of a tax that was more and more difficult to administer and pay. Thus, began a spiral of Government and contractor actions and counter-actions that resulted in attempts by both parties to better define the tax pricing and payment process in an effort to reduce the administrative burden involved in FRET payment.

Eventually, what may have been intended as a simple tax to support the Federal Highway system through excise tax payments by truck and trailer manufacturers, became a significant burden to defense contractors, DOD, and the Treasury Department over legitimate issues of applicability and interpretation. A possible explanation for this is that the tax statute was not designed to address the unique aspects of the military application and usage of its Tactical Wheeled Vehicle fleet. Despite efforts by the Army to interpret the statute, and provide detailed guidance on the FRET calculation and payment process, both before and after contract award, and to make any FRET changes as administratively simple as possible, by supplementing the standard FAR clauses with local TACOM

provisions that better define the actual payment process, the Army and its contractors continue to argue, negotiate, disagree, and in the worst cases, litigate FRET issues.

D. SUMMARY

This chapter discussed the genesis of the FRET statute, and some of the major changes to the statute since its inception. It also identified those DOD vehicle systems covered by the statute, and the manner in which DOD implements this tax through FAR provisions, as well as Command level clauses. The history of these Command level clauses was addressed, which provided a basis for reviewing tax issues between the Army, its contractors, and the IRS. Such a review leads to a discussion of the burden this tax places on the Army and its contractors, and the history of its application on the various Tactical Wheeled Vehicle programs to which it currently applies. These historical FRET issues and the various litigations between the parties are discussed in Chapter III.

III. FEDERAL RETAIL EXCISE TAX PAYMENT ISSUES AND LITIGATION: AN HISTORICAL PERSPECTIVE

A. OSHKOSH TRUCK CORPORATION – HEAVY EXPANDED MOBILITY TACTICAL TRUCK

In May 1981, the Army awarded its first billion-dollar, multiyear Tactical Vehicle contract to Oshkosh Truck Corporation (OTC) for the Heavy Expanded Mobility Tactical Truck (HEMTT) program. [Ref. 7] This was a non-developmental item (NDI) procurement that called for delivery of several thousand vehicles over a five-year timeframe. This acquisition was conducted under competitive formal advertising procedures that did not require the submission of certified cost and pricing data by the bidders. It was a fixed price contract with an Economic Price Adjustment (EPA) clause that allowed for a change in vehicle prices under certain economic conditions. It also required the pricing of specific models with and without FET (prior to 1983 the FRET tax was referred to as FET and was calculated at 10% instead of 12% of the vehicle cost) due to Army plans to ship certain vehicles to overseas destinations. During the acquisition planning phase, TACOM had attempted, in conjunction with its headquarters, the Army Materiel Command, and the Army Judge Advocate General's Tax Division, to define the HEMTT as an off-road vehicle that would be exempt from FET. When the IRS denied this request for exemption, the resultant contract specified FET CLINs for vehicles scheduled for CONUS shipment. Since vehicles were to be shipped to both CONUS and OCONUS destinations, the Army had set up separate Contract Line Item Numbers (CLINs) for each of the various vehicle configurations (Cargo, Wrecker, Tanker, etc.) to reflect the with and without Federal Excise Tax (FET) price for each model. Domestic

vehicle prices were to include all applicable Federal, State, and Local taxes, including FET. Thus, at the time of the contract award to OTC, domestic vehicles for all five years of the multiyear contract were assumed to have the correctly calculated applicable taxes included in the vehicle prices. The Army's confidence that this was indeed the case, since certified cost and pricing data were not required from the bidders, resulted from the bid prices for each model that reflected apparent differences in the price of vehicles destined for domestic versus foreign shipment.

On 1 April 1983 the Highway Revenue Act of 1982 took effect, changing the FET rate and the basis upon which it was to be calculated. In addition to changing the tax rate from 10 percent to 12 percent, it changed the basis upon which the new FRET would be figured from the "constructive sales price" to the "retail sales price." In accordance with the contract Federal, State, and Local Taxes clause, OTC submitted its proposal for equitable adjustment, as a result of this change in the tax law. After a review by various DOD contracting officials, and a cooperative regional IRS agent in Milwaukee, the contract was modified to revise the vehicle prices. Within a year of this modification, it became apparent that, despite IRS review and concurrence, OTC had incorrectly calculated the revised vehicle prices. In addition, internal OTC financial documents indicated that it had over-deposited money to the IRS for previous FET payments on contract vehicles in amounts substantially higher than its actual FET liability. As a result, OTC requested and received a refund from the IRS in the amount of two million dollars.

At about the same time it had received its refund from the IRS, OTC requested additional funding from the Government to cover additional FRET payments due to an increase in base vehicle prices resulting from the EPA provisions of the contract. In

addition, other FRET issues arose under this contract. Significant technical and performance problems resulted in the Government conditionally accepting vehicles and storing them at Government depots and contractor facilities for an extended period of time. Some of the vehicles destined for foreign locations were stored for several years before being retrofitted to the latest agreed upon configuration and finally accepted by the Government. [Ref. 48] As recounted by one of the contract specialists working the program at the time: [Ref. 19]

> Yes, I recall that time period...I can even remember that I was thinking out of the box even back then and tried negotiating lots of different scenarios with the IRS...I recall that at one point I lightly threatened Schlaak (the IRS representative) that before the Army would pay FET on all those vehicles (that were OCONUS) that we'd put all of them on a ship and run them out to the 12 Mile limit to render them EXEMPT! [I recall this solution was not considered very seriously...and there was some talk about fraudulent deception and jail...]
>
> I also recall that we tried that "further manufacture" excuse with the HEMTTs. It didn't work. The IRS/Schlaak had a specific definition of "further manufacture" and the (fact that) 'we-conditionally-accepted-these-vehicles-but-they-don't-work-and-need-to-go-to-the-depot-for-retrofit' did not fit their definition. We didn't successfully argue that point (with) the HEMTTs.
>
> If you recall, the Army had advance paid FET for...the HEMTT vehicles. First we had to prove that all of the vehicles (that required FET) had imbedded FET in their...two-step firm-fixed price. Then we had to come up with a formula to a) back out the tax, and b) back out the cost of the tires and the associated tax on the tires, then c) determine the base price of the vehicle with no FET, and d) recalculate the FET. After that we began the recover(y) of the FET for all vehicles we could prove got out of the country within the 6-month window of acceptance, and were still out of the country.
>
> SET-IN-STONE-RULE: When the DD250 is signed (conditional, provisional, or otherwise)...the 6-month clock starts. There ain't (sic) no

way around this.

Thus, after performing its routine contractor audits, the IRS assessed the contractor FRET costs against vehicles destined for OCONUS deliveries, because they had not left the country within six months after vehicle delivery. Although this interpretation could be made from the FRET statute, the contractor and Army contention was that since the vehicles were only "conditionally" accepted pending final configuration approval, the vehicles in question should not be considered accepted as intended by the statute. The discussions between the various parties: the IRS, the contractor, and the Army were protracted because the IRS did not recognize the Army as an interested party, as it was not the taxpayer of record. [Ref. 19, 35] After much discussion, and a willingness by the Army to agree to the IRS demand that this not be a precedent setting case, the IRS, although not agreeing with the Army's contention that the vehicles weren't finally accepted until the final configuration was agreed to between it and the contractor, did eventually agree to exempt these vehicles from the tax, provided the Army show proof that the vehicles had been shipped out of the country within three years of it's initial conditional acceptance. [Ref. 35, 50]

As a result of the technical issues, OTC eventually submitted an REA alleging that the Government misinterpreted its own specification requirements, which resulted in over-testing and the use of an oversized axle with a higher GVW (Gross Vehicle Weight) rating than was necessary for the HEMTT vehicle family. The Army denied the OTC REA, which resulted in its submission of a certified claim against the Government on 12 March 1986, and protracted litigation. [Ref. 48] Although the litigation issues were

centered mainly on performance requirements that resulted in OTC having to incorporate more expensive, oversized axles to various HEMTT models, to meet Army performance requirements, it also asserted that the Army owed additional FRET payments to OTC in the amount of $2.7 million.

Although ultimately settled out of court, with the Government paying OTC four million dollars to resolve all outstanding issues related to its claim, many years were spent by both parties in preparing for litigation. This included putting together summary documentation, coordinating with legal staffs, taking depositions and preparing other court documents. In addition, the Government spent much time in preparing what may have been the first of its kind counterclaim against OTC, alleging false statements and faulty data in support of its claim that the Government over-tested its vehicles. [Ref. 48]

B. AM GENERAL CORPORATION – M939 SERIES FIVE TON TRUCK

In September 1981, the Army awarded another billion-dollar, multiyear tactical vehicle contract to AM General Corporation (AMG) for the procurement of several thousand M939 Series Five Ton Tactical Trucks for the Army, Air Force, Navy, Marine Corps, National Guard Bureau, and the Army Reserves. [Ref. 6] During the life of this contract the Army also added vehicles for several foreign military sales (FMS) customers. This procurement was accomplished via formally advertised, competitive procedures that did not require the submission of certified cost and pricing data. It was also a fixed price contract with an EPA clause.

The M939 Series vehicle, like its predecessor, was procured using non-developmental item (NDI) techniques. [Ref. 30] As a result of the NDI nature of this procurement, several of the design characteristics were relatively immature, as the

various commercial components had never been integrated into a military designed vehicle, which required tougher performance standards necessary to operate in a military environment. As a consequence, during the course of First Article Testing (FAT), and subsequent vehicle system fielding to military units, hundreds of engineering changes were required to meet Army detailed specification requirements. In those cases where the Government was responsible for these changes, the contracting officer was required to negotiate a change to the contract vehicle price. These and other changes requiring re-negotiation of vehicle prices, such as changes in vehicle destinations from OCONUS to CONUS or vice versa, would often lead to protracted discussions with the contractor over the impact to the FET portion of the vehicle price. Numerous disagreements occurred between the parties that resulted in extensive discussions and separate informal inquiries to the IRS, in an attempt to determine the correct interpretation on many of the FET issues. It was during the course of administering this contract that the Army became aware that a bid price, which by the Federal Acquisition Regulation should be obvious on its surface, might not be as transparent as the Army wanted to believe. [Ref. 28, 33] In the mind of the Army contracting officer, a change in vehicle destination from domestic to foreign and vice versa should have been as simple as changing one of the 14 vehicle configurations from a CLIN that included FET to one that did not include the tax. However, even in those cases where specific configuration changes were not a factor, the contractor argued that, due to the multiyear requirement for "level pricing" of all program years, the manner in which it structured its bid prices required it to align certain costs, such as overhead, G&A, profit, and tax, in ways that made the Government interpretation of its CLIN prices meaningless for the purpose of making after award changes. [Ref. 28,

33] In the case of this first Five Ton Truck multiyear contract, AMG also argued that even without the requirement for level pricing it "hid" certain cost elements, such as tax and profit, as a "bid strategy" to keep the true cost factors, making up its bid price, from its competitors. Consequently, any and all changes that impacted vehicle pricing resulted in lengthy and contentious negotiations that were exacerbated by sometimes strongly divergent views, by each of the parties, on the manner of calculating FET when revising the vehicle prices. [Ref. 28, 33]

Although the parties were eventually able to resolve all pricing issues, without resorting to litigation, many of the required changes were placed on contract via ceiling price modifications, and negotiated after-the-fact, due to the inability of the parties to come to agreement in a time-frame necessary to meet program requirements. The result was considered to be an administrative nightmare by those involved for both the Government and the contractor, because numerous issues were resolved only after protracted negotiations, based on actual costs, with very little incentive for either party to come to agreement in a timely manner. Although all of these actions could not be blamed on the FET issue, FET was said to have played a significant role in many of these contract change negotiations, some of which took years to resolve.

C. OSHKOSH TRUCK CORPORATION – LOGISTICS VEHICLE SYSTEM

In September 1983, the Army awarded a several hundred million dollar, five-year, multiyear contract for the US Marine Corps (USMC) Logistics Vehicle System (LVS). [Ref. 8] This was a sole-source negotiated contract, and was very similar to the HEMTT contract in that the vehicle was a "HEMTT-like" configuration with significant anomalies required to meet unique USMC mission requirements, and both were fixed price with

EPA provisions. But, as a negotiated contract, the proposed LVS vehicle prices required the submission of formal Cost and Pricing data from OTC, and contained supporting documentation that identified FRET amounts for those vehicles being shipped to CONUS destinations. As a result, it was thought that this would enable the parties to avoid many of the FRET (FET) issues that dogged previous tactical vehicle contracts.

However, despite a better awareness by both parties of the FRET portion of vehicle prices, an issue that was previously raised in the HEMTT contract also manifested itself in the LVS contract. Thus, in June 1986 OTC submitted a certified claim requesting the upward adjustment of vehicle prices for the alleged non-inclusion of FRET in the vehicle EPA base. The position of the Army contracting officer, in denying the claim, was the same as in the HEMTT contract. She argued that the tax clauses contained in the contract represented an agreement between the parties that all applicable taxes payable or scheduled to be become payable during the life of the contract were already included in the contract price. OTC argued that when the EPA clause operates to increase vehicle prices, the Government should separately fund the resulting increase in FRET. This issue was ultimately resolved in conjunction with the settlement of all FRET issues under the 1981 HEMTT contract. However, a contracting office review of the original HEMTT contract and this LVS contract, in anticipation of the HEMTT Rebuy contract in 1987, concluded that standard FAR clauses were inadequate to address complex FRET issues that arise during the contract administration phase of Army tactical vehicle contracts. [Ref. 48]

D. BMY CORPORATION – M939A2 SERIES FIVE TON TRUCK

On 14 May 1986, the Army awarded a new billion-dollar contract for the next generation Five Ton Truck, the M939A2 Series. [Ref. 9] BMY Wheeled Vehicle Division of Marysville, OH ultimately performed the awarded contract. This division of BMY resulted from a teaming arrangement between ARVECO of Ann Arbor, MI (to whom the contract was originally awarded) and BMY Corporation of York, PA. The M939A2 differed from the M939 series of vehicles in two significant ways. It had a new, more modern engine and the added feature of a Central Tire Inflation System (CTIS). Both changes were significant, and provided the Army a vehicle system that was intended to have better reliability and increased performance from its predecessor vehicles in its mainly off-road combat support mission.

This was the last major vehicle system contract let by the Army using Two-Step Formal Advertising (FA) procedures to solicit for its requirements. Although changing regulations de-emphasizing Formal Advertising (e.g., the Competition in Contracting Act (CICA) of 1984), as DOD moved toward significant acquisition reform in the 1990s, played a minor role, the real reason for this TACOM policy change was the role FRET played in the award decision. [Ref. 5; Appendix B, para. 1]

The Two-Step Formal Advertising method of procurement requires that interested contractors submit only technical proposals during Step One of the process. No cost or pricing information is provided at any stage of the process, as long as the Government determines that adequate price competition exists. The Government then evaluates the technical proposals. Those contractors that have submitted acceptable technical proposals in Step One are then invited to submit priced bids during Step Two of the

process. The Government conducts the Step Two process in the same manner as any other Formally Advertised procurement. Bidders are notified ahead of time of the public bid opening date and time, and all interested parties are invited to attend the bid opening. As in all Formally Advertised procurements, the Government requirements must be known and expressed clearly in the solicitation document. Once the public bid opening has taken place and the "apparent low bidder" has been established, no substantive discussions concerning the bidders' actual bid documents can take place between the Government and the bidders while the Government is evaluating the bids to determine the actual low bidder. The reason is that each bidder's offer must speak for itself, and be clearly responsive to Government solicitation requirements. Additionally, as indicated above, selection is based strictly on price competition, and submission of formal Cost and Pricing data by bidders is not required, unless a determination has been made that adequate price competition does not exist.

For the M939A2 procurement, three bidders participated. These included (1) the previous M939 producer, AMG; (2) a new bidder for tactical vehicle contracts, Stewart & Stevenson Services, Inc. (S&S); and (3) the eventual awardee, BMY, Tactical Vehicle Division. As with most high dollar, complex vehicle programs, the M939A2 program had significant high level Congressional, DOD, and Army interest that encouraged the avoidance of program delays. It was in this environment that the bid opening was scheduled for noon on 14 April 1986. Several days prior to the bid opening, BMY (ARVECO) requested verbal clarification regarding the solicitation, which called for the bidders to provide both with and without FRET prices for all vehicle models for all five program years covered by the proposed contract. The genesis of the BMY question was

that, unbeknown to relevant Army procurement officials at the time, the FRET statute was due to expire in September 1988, unless reinstated by Congress, as it had been every five years since its inception. [Ref. 52] Since the proposed five-year multiyear contract was to cover the time period from 1986 through 1990, this created a conflict in the minds of the BMY bid preparers, as to whether or not to include FRET in the out years, despite solicitation instructions.

Once Army procurement officials convinced themselves that the FRET statute was indeed scheduled to expire prior to the end of the proposed contract, and believing that the law would be reinstated for another five years, and, further, feeling the political pressure to avoid any additional program delays, they verbally responded to BMY that it should submit its bid in accordance with solicitation instructions, notwithstanding the status of the FRET statute. [Ref. Appendix B, para 2] In the mind of Army officials, this seemed the most prudent course of action to avoid program delays and assure a level playing field for all the potential bidders. Since it had not received similar inquiries from the other contractors involved in Step One of the solicitation process, it wrongly assumed that the other potential bidders were not aware of the status of the FRET statute, and would bid according to solicitation instructions. [Ref. Appendix B, para 3]

Upon bid opening, which was delayed several hours due to an inquiry from one of the other bidders unrelated to the FRET issue, the apparent low bidder was determined to be BMY. Its bid was $97 million less than the second low bidder, AMG, the current producer. However, along with its bid, BMY had provided a letter reducing the unit price of each vehicle across the board by $2,065 for the base quantities (excluding option quantities) without regard to whether they were listed in the solicitation as "FRET:

Applicable" or FRET: Not Applicable." Shortly after the formal bid opening, Army procurement officials began evaluating the bids to assure the low bid was responsive to the Government solicitation, that the contractor was a responsible bidder, and that other evaluation criteria, such as Government transportation costs, did not displace the apparent low bid.

It was during the evaluation phase that a verbal discussion between an Army procurement official and a BMY representative led the Army to believe that the BMY bid reduction letter constituted removal of FRET for those vehicles to be shipped after September 1988, and, thus, constituted an exception to the solicitation requirements, and rendered its bid non-responsive. When asked for clarification by the Government, and notified of the potential Army non-responsiveness determination, should the Army interpretation be correct, BMY rescinded its verbal explanation regarding the bid reduction letter, and provided written clarification that its bid did indeed include FRET for all program years, as was apparent on its bid document. [Ref. Appendix B, para 4] After completing its evaluation, the Army determined BMY to be the low, responsive and responsible bidder, and awarded it the M939A2 multiyear contract on 14 May 1986.

On 19 October 1987, during the second year of the contract, BMY submitted an REA for $95 million to reflect an after-imposed Federal Retail Excise Tax (FRET), as a result of the extension by Congress of the FRET statute, stating that it had not included these "after-imposed" taxes in its bid price. On 5 January 1988, the contracting officer denied the BMY request stating that the bid on its surface, and its bid clarification letter submitted after bid opening, indicated conformance to contract requirements, which called for the inclusion of FRET for all program years. On 9 February 1988, BMY

submitted a certified claim requesting a contract price adjustment for the after-imposed FRET, which was also denied in a "final decision" by the contracting officer on 25 March 1988. [Ref. 28] BMY then timely appealed the contracting officer's final decision to the ASBCA. [Ref. 1]

On 5 October 1990, BMY submitted an additional certified claim requesting the contracting officer make a contract price adjustment to reflect unilateral Government changes in shipping destinations, between CONUS and OCONUS. This claim was amended five times by claim amendments dated 18 December 1990, 24 January 1991, 30 January 1991, 8 February 1991, and 18 February 1991. This claim, and its amendments, involved some of the same basic questions of fact, as the original FRET claim. On 18 March 1991, the contracting officer issued his final decision denying this additional BMY claim. On 11 Jun 1991, while the original FRET claim was still pending before the ASBCA, BMY timely appealed to the ASBCA the denial of its change in shipping destinations certified claim. [Ref. 4] As a result of an Army and BMY belief that a decision in ASBCA No. 36805 could help resolve the issues associated with ASBCA No. 43042, the Army and BMY jointly moved that the appeal be dismissed without prejudice, which was granted.

After several years of trial preparation and an ASBCA trial, the ASBCA found for the contractor on the issue of entitlement on 4 January 1993, and requested the parties work together to settle the quantum issues. [Ref. 2] It was during this timeframe that the Department of Justice initiated a fraud investigation regarding BMY's submission of misleading acceptance documents relating to the FRET issue. [Ref. 44] On 3 February 1993 the Government requested a reconsideration of the Board's decision based upon

newly discovered documentation calling into question the BMY statement of facts, as recounted at the ASBCA trial. [Ref. 3] On 24 February 1994 the Board denied the Government request. On 22 June 1994, the Government subsequently appealed the ASBCA decision to the US Court of Appeals for the Federal Circuit, which dismissed the Government's motion on 16 August 1994. At the urging of the ASBCA judge, to avoid the expense, delay, and inconvenience of additional protracted litigation relating to these matters, and in an effort to resolve all FRET issues once and for all, the Army and Justice Departments finally settled with BMY on all administrative and criminal matters relating to FRET on 19 September 1995 in the amount of $49 million. [Ref. 44] In addition, the Army agreed to pay up to $21 million should BMY be unsuccessful in its efforts to settle an unrelated FRET issue between it and the IRS, as to the taxability of the M923A2 and M925A2 cargo vehicles. As of December 2000, BMY, Army representatives, and the IRS are still litigating this unrelated issue. After unsuccessful mediation attempts, BMY and the IRS are currently preparing to go to Federal Tax court in an effort to settle this long outstanding case. [Ref. 16]

As a result of the significant, costly, and time-consuming issues that resulted from the Army's inability to hold serious discussions with all the proposed bidders after bids were revealed, and the FRET issue was identified in Step Two of this formally advertised procurement, the TACOM Principal Assistant Responsible for Contracting (PARC) at the time, Mr. Henry Jones, instituted an informal policy that no major weapon system would ever be bought again using the Formal Advertising (now Sealed Bidding) method, no matter how clearly Government requirements were defined.

E. OSHKOSH TRUCK CORPORATION – HEAVY EXPANDED MOBILITY TACTICAL TRUCK REBUY

In April 1987, the Army awarded a billion dollar, follow-on, five-year multiyear contract to OTC for the procurement of additional HEMTT vehicles. [Ref. 10] In that same month, Congress enacted the Surface Transportation and Uniform Relocation Assistance Act of 1987. [Ref. 39] This Act amended Title 26, Section 4052 of the Internal Revenue Code relating to the excise tax levied on heavy vehicles, to add a subsection that required the payment of a "presumed markup" for the purpose of imposing the tax based upon retail, as opposed to a wholesale, or otherwise discounted price. The resultant regulation provided that, with certain exceptions, the presumed markup percentage would be four percent. The exceptions to this additional tax were, "trailers, semitrailers, and remanufactured automobile truck chassis and bodies and tractors." Upon learning about the Act, several DOD truck manufacturers, including OTC, came to the Army requesting additional contract funding to cover this "after-imposed" tax. After reviewing the case law and legislative language concerning this piece of legislation, the Army determined that the proposed legislation was not intended to apply to the Army purchase of military vehicles acquired through competitive procedures directly from vehicle manufacturers in an "arms length" manner. [Ref. 15; Appendix B, para 5] Because of this determination, the Army provided guidance to all its Medium and Heavy Tactical Wheeled Vehicle manufacturers that this additional tax levy did not apply to Army vehicles, and that they should dispute any such levy by the IRS. [Ref. 38]

Despite the Army interpretation and guidance to its contractors, the IRS assessed this additional tax on defense contractors providing applicable vehicles to DOD. In

regard to this particular "presumed markup" tax, the Army was so certain of its position that it refused to pay its contractors, even after the contractors provided proof that the IRS was levying such tax. In addition, the IRS was requiring DOD contractors to pay the tax, with interest and penalties, when losing their disputes with the IRS. In essence, DOD truck manufacturers were being held hostage in a dispute between the Army and the IRS. Because the IRS refused to hold direct discussions with the Army over the issue, using the reasoning that the Army was not "the taxpayer of record," DOD contractors had to pay taxes to the IRS without restitution from the Army. After several years of sometimes very hostile discussions between the various parties to this dispute, including the three largest Army wheeled vehicle contractors at the time (OTC, BMY, and Freightliner Corporation (FTL)), the issue came to a head in 1993 when OTC, under its 1987 HEMTT contract, submitted an REA for more than three million dollars to cover all presumed markup taxes, including interest and penalties.

At this point, the Army decided to pursue two courses of action. First, it determined that holding its contractors hostage to a dispute between it and the IRS was not a prudent business decision, and it proceeded to obtain funding and pay its contractors for this "after-imposed" tax increase. Secondly, it requested that OTC, as a taxpayer of record, pursue legal remedies against the IRS to obtain a refund of the presumed markup tax, on the grounds that the law was not intended to apply to the Army purchase of tactical wheeled vehicles. [Ref. 40] After reviewing the applicable tax statutes with its legal counsel, OTC responded to the Army that it did not believe it had a strong enough case to justify the legal costs involved in pursuing the requested action. After conferring with senior Army tax specialists and obtaining their approval, TACOM

procurement officials decided on a drastic and possibly precedent setting course of action. In January 1994, the Army issued a supplemental agreement based upon a mutual agreement of the contracting parties, whereby it provided funding to OTC to pay any and all reasonable legal fees associated with the pursuit of a legal remedy from the IRS, as follows: [Ref. 11]

> Pursuant to FAR 52.229-4, Federal, State, & Local Taxes, the Contractor will pursue legal action with the Internal Revenue Service (IRS) for a refund of the four percent Presumed Markup on Federal Retail Excise Tax, and obtain a decision regarding the applicability of this Markup, up to the point of requesting a Motion for Partial Summary Judgement and receiving a decision. The Contractor will submit to TACOM, AMSTA-ISBB, copies of all pleadings filed by all parties to the litigation, and a copy of the final decision.
>
> As a result of this effort, the Contractor and the Government (TACOM) hereby agree that CLIN 8021 will be added to this contract at a total price of $43,800. This CLIN is a cost reimbursable line item for actual costs that are incurred as a result of this effort up to and receiving a decision. TACOM will then review the results of the legal action up to that point and will then decide if further action will be necessary.

On 12 September 1997, ten years after award of the HEMTT Rebuy contract and the implementation of the presumed markup tax, the United States Court of Appeals, Federal Circuit, reversed and remanded a previous Court of Federal Claims decision in favor of the IRS. [Ref. 25] The result was that DOD contractors were exempted from payment of the presumed markup tax on vehicles sold directly to the United States Government. In addition, all previous such taxes paid were refunded through the respective DOD vehicle manufacturers to the US Army.

An interesting irony to this particular case is that the money refunded by the IRS, through defense contractors to the Army, had expired in accordance with Congressional

budget policy regulations, and was returned to the Secretary of the Treasury for input into the general fund. Thus, the Army was unable to use this additional funding source to procure additional vehicles, as originally authorized by Congress.

F. STEWART & STEVENSON SERVICES, INC. – FAMILY OF MEDIUM TACTICAL VEHICLES

On 11 October 1991, the Army awarded another billion-dollar, multiyear vehicle contract for the Family of Medium Tactical Vehicles (FMTV) to Stewart & Stevenson Services, Incorporated (S&S). [Ref. 12] This contract was for a new family of two and a half and five ton vehicles that would eventually modernize the Army's Medium Tactical Vehicle fleet by replacing all current vehicles in the field, some over 30 years old. Using competitive negotiation procedures, the Army conducted a two-phased process, whereby initial proposals were requested for the manufacture and testing of prototype vehicles, to be followed by production proposals from those offerors successfully completing the prototype phase of the competition. In each phase, successful offeror(s) were determined by formal Source Selection procedures that consisted of a Source Selection Evaluation Board (SSEB), a Source Selection Advisory Council (SSAC), and a Source Selection Authority (SSA). In each of these phases, offerors were provided with a performance specification and given extensive latitude in designing and producing a new generation Medium Tactical Vehicle fleet that would take advantage of state-of-the-art technology that was missing from the design specification-driven fleet currently in the DOD inventory. The Government then spent several months during each phase conducting an extensive evaluation of each offeror's technical, management, production, and cost proposals.

As a result of past FRET issues, TACOM, in an effort to further define and simplify the FRET payment process, took the additional step of including a cost-reimbursable Contract Line Item Number (CLIN) within the fixed-price solicitation, to put offerors on notice that the Army would only pay the winning contractor the amount of FRET ultimately paid to the IRS. [Ref. 12] Due to disagreements on prior contracts over the amount of FRET paid by the contractor to the IRS, the Army determined that the best way to assure that it only paid the contractor the amount of tax it actually paid to the IRS, was to separate FRET from the fixed-price vehicle CLINs, and force the contractor to provide proof of payment to the IRS, before payment under the cost-reimbursable CLIN would be funded under the contract. What the Army did not count on was the impact FRET would have on technical design decisions made by the offerors during the solicitation phase, and design changes requested by the Government after contract award. Although not directly tied to the manner in which the Army had determined to implement FRET payment under this new contract, Army procurement officials involved at the time, believe they had unwittingly created a situation where potential offerors, in an effort to gain a competitive cost advantage, designed vehicles at reduced weights. [Ref. 29] This was never proven, or even formally investigated by the Army, but this scenario created an environment where offerors were incentivized to reduce vehicle weight for reasons other than meeting Government performance specifications, at the least cost to the Army. Thus, the motive existed to reduce vehicle weight solely to gain a competitive advantage rather than for sound technical reasons, by designing as many of the 14 different models as possible under the FRET tax-evoking weight of 33,000 pounds GVW for trucks. By being the offeror that has the largest number of models under 33,000 pounds GVW, a

contractor would have a distinct cost advantage of 12 percent per model (the amount of the tax) over its competitors. In addition, the Army would not be able to evaluate the legitimacy of the proposed weight of the majority of the models proposed by each of the offerors until after contract award, because only a few of the models were required to be built and tested in the prototype phase of the competition. [Ref. 20]

This issue became apparent to the Army during the evaluation phase for the production contract. During the SSEB evaluation, it was discovered that different offerors had significant differences in proposed vehicle weight for the various models. Evaluator suspicions over the large diversity in the number of models below 33,000 pounds GVW between one offeror and the other two offerors led them to suspect more was involved than just technical differences. Although each contractor was queried extensively on the various technical aspects and resultant weight issues with each of their proposed models, ultimately, the Government could not make a case that the design estimates and assumptions made by the various offerors were unreasonable or technically insufficient. Thus, no direct correlation between vehicle design and FRET impact could be substantiated during the evaluation phase of the selection process.

From the competitors' perspective, the competition for this billion dollar, multiyear contract could potentially rest on their various model weight calculations, as a result of the weight impact on FRET applicability, and its impact on total contract price. In the case of those model variants where offerors were not required to build prototype vehicles, they would have to make a decision, as to whether or not FRET should be included in their vehicle price, based upon a paper design and the accuracy of their weight calculations. If they included FRET in the vehicle price and the actual production

vehicle built under the contract was less than 33,000 pounds GVW, then they included unnecessary costs in their bid, which could potentially lose the competition for them. On the other hand, if they did not include FRET due to weight considerations, and the vehicle, as built, exceeded this weight requirement after contract award, they would be responsible for this additional financial liability. [Ref. 29]

After an extensive evaluation process, contract award was made on 11 October 1991, to S&S, the contractor with the least number of models exceeding the GVW for FRET purposes (only four of the 14 models, as awarded, were estimated to exceed the 33,000 pounds GVW). After contract award, and in some cases prior to actual vehicle production, Government directed Engineering Change Proposals (ECPs) were incorporated into the contract to meet new user directed requirements, address safety issues, or rectify test deficiencies. Historically, it is not unusual for a large, complex defense acquisition program to make design changes after contract award. However, such changes are more likely to occur on this type of NDI program, where commercial components are integrated for the first time in a manner not normally seen in commercial applications, due to off-road and combat scenarios necessary to meet military requirements. It was due to these Government directed engineering changes, and their supposed increase to GVW on previously non-FRET applicable models, that S&S requested that the contracting officer increase the contract by over nine million dollars. [Ref. 34] Although initially taking a position that the Government was not responsible for vehicle weight miscalculations by the contractor, during the solicitation phase of the program, the Army's current position is that the contractor is entitled to consideration due to these post-award Government directed changes. The Army is currently negotiating

with the contractor to reach agreement on the exact amount of remuneration necessary to cover these Government directed changes.

G. COMPETITIVE COMMERCIAL VEHICLE ACQUISITION

As recently as Fiscal Year (FY) 2000 another commercial vehicle acquisition was impacted during the evaluation phase, when an SSEB member noticed that the difference in one of the offerors 'with' and 'without' FRET prices were significantly larger than the approximate 12 percent figure normally seen by the Government. Instead, the prices were almost 17 percentage points apart. When queried by the Government evaluators, the offeror corrected its prices, after realizing it had made a mathematical error. As a result, its proposal price was reduced by over $12 million, which took it from second low to the low offeror. When completion of the technical evaluation determined that the first and second low offerors were approximately equal, this contractor won the award based on price. If not for this chance discovery on the part of a Government evaluator, the Army could potentially have paid more than necessary by awarding to the higher priced offeror. [Ref. Appendix B, para 6]

H. SUMMARY

As evidenced by the case studies contained in this chapter, the Army and its contractors have wrestled with the issue of FRET for many years and in many ways, in an effort to meet the intent of the law in the most effective way possible. Despite these efforts, FRET continues to be an issue that is cause for disagreement and significant discord between the Army and its contractors.

Thus, this longstanding issue continues to impact the Army, and the manner in which it procures its tactical wheeled vehicle fleet. Despite discussions, negotiations, Alternative Disputes Resolution (ADR) efforts, and litigation decisions, between the Army and its major wheeled vehicle manufacturers over the last 19 years, it appears to be a continuing source of contention that has yet to be resolved to the satisfaction of either of the contracting parties. In the Chapter IV we discuss the actual cost of FRET, both direct and indirect, to the Army, its contractors, and the taxpayer.

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IV. THE COST OF FEDERAL RETAIL EXCISE TAX

A. THE ARMY TACTICAL WHEELED VEHICLE FLEET

A discussion of the cost of FRET would not be complete without a description and an accounting of the size of the Army fleet of tactical wheeled vehicles. [Ref. Appendix B, para 7] Per the Army Tactical Vehicle Fleet Book '98: [Ref. 51]

> The Army's Tactical Wheeled Vehicle (TWV) fleet is the backbone of the warfighting and sustainment structure for our troops on the battlefield. Each fleet is designed to play an integral part in the combat scenario. The light fleet meets the basic transportation needs for unit commanders, ambulances, and communications and weapon platforms. The medium fleet serves as the primary mover of unit equipment and personnel. The heavy fleet provides transportation for bulk quantities of fuel, ammunition, and other supplies, and for deployment of combat vehicles and combat engineer equipment.

Specific data on that part of the fielded fleet subject to FRET when newly procured are as follows: [Ref. Appendix B, para 8]

	Medium Trucks & Trailers	Heavy Trucks & Trailers
Density of Trucks:	96,210	26,440
Age Range:	New – 27 years	New – 20 years
Average Age:	18.7 years	10.8 years
Density Trailers:	64,113	25,281
Average Age:	8 – 31 years	15.2 years

Table 1 – Size of Tactical Wheeled Vehicle Fleet Subject to FRET

The entire Tactical Wheeled Vehicle fleet, including Army Reserve and National Guard units, as of January 1999 consisted of 357,075 vehicles. The estimated yearly cost to operate and support this fleet is $1.7 billion. [Ref. 43] The operation and support cost drivers, as determined by the TACOM Fleet Planning office are labor and mechanics; spare parts (e.g., engines, tires, batteries); and petroleum, oil, and lubricants. As

evidenced by the above data, the Army tactical vehicle fleet is an aging fleet that requires significant cost to operate. Various DOD and Army programs have been designed to provide the various Military Services with opportunities to reduce operational and support costs in an environment where defense budgets continue to shrink. Some of these programs include Modernization Through Spares (subsequently renamed Continuous Technology Refreshment), Horizontal Technology Integration, Operation and Support Cost Reduction, and Industry Research and Development Programs. [Ref. 43] However, the most effective long-term method of significantly reducing operational and support costs is to rebuild, remanufacture, or buy new vehicles. It is in these areas that the affect of FRET on vehicle prices has a significant impact. For rebuild or remanufactured vehicles a companion statute within the FRET law provides that FRET is not applicable to "repairs or modifications...if the cost of such repairs and modifications does not exceed 75 percent of the retail price of a comparable new article." [Ref. 53] Thus, in an effort to preserve scarce dollars, program offices have been known to design rebuild and remanufacture programs to limit desired upgrades to stay within this 75 percent FRET limit. [Ref. 42] For the procurement of new vehicles, the FRET impact on vehicle prices determines the ability of DOD to reduce operational and support costs, within its yearly procurement budget, by timely replacement of an aging fleet, as "additional economies are introduced by retiring low-density systems and replacing the multiplicity of makes and models, each with its own unique support requirements, with a 'Family' of vehicles with common logistical support." [Ref. 51]

B. THE COST OF FEDERAL RETAIL EXCISE TAX TO THE ARMY

Detailed data on the actual cost of FRET are difficult to compile because the Army does not specifically identify FRET when calculating its proposed budgets as part of the Program Objective Memorandum (POM) cycle for Tactical Wheeled Vehicles. Although individual programs that are subject to FRET do include a line item within their respective budget submissions, which are subject to scrutiny and must be defended, just as any other cost, the difficulty in accounting lies in the execution phase of a program. Once funding has been obligated on a DOD contract, tracking the amount of actual FRET paid is impacted by contract management actions such as delivery changes (OCONUS vs. CONUS) and the incorporation of Engineering Change Proposals (ECPs). This makes efforts to reconstruct FRET payments to our contractors difficult. Due to the nature of the DOD Planning, Programming, and Budgeting System (PPBS), elaborate and sophisticated accounting techniques are employed to estimate, extrapolate, and project future budget needs. As a result, the Army budgets for FRET in a very general sense, and rarely considers the collective cost of FRET across all budget lines. [Ref. 13] Thus, detailed cost estimates in regard to FRET payments are not routinely included in overall Army program budgets. However, a rather simple estimate of FET/FRET payments, from an historical perspective, is possible by approximating payments for programs between 1981 and 1995, as identified in Chapter III. Table II attempts to depict a conservative estimate of actual FET/FRET payments by the Army for tactical wheeled programs during this time period.

In addition to actual FRET payments made by Army contractors to the IRS, the Army and the other Military Services pay for FRET in a myriad of ancillary and administrative actions to assure compliance by it and its contractors. These include lost

opportunity costs, record keeping costs, contract management costs, investigation and audit costs, solicitation preparation and proposal evaluation costs, and negotiation and litigation costs.

Program	Years	Approx Funding	Approx FET/FRET*
HEMTT	1981-1985	$1 Billion	$100 Million
M939 5 T Trk	1981-1985	$1 Billion	$100 Million
LVS	1983-1987	$200 Million	$ 24 Million
M939A2 5 T Trk	1986-1990	$1.1 Billion	$132 Million
HEMTT Rebuy	1987-1991	$1 Billion	$120 Million
FMTV 5 T Trk	1991-1995	$1.3 Billion	$156 Million
Estimated FET/FRET for Army Tactical Vehicles from 1981-1995			$632 Million

[Source: Developed by Researcher]
*Note: Prior to 1983 FET was calculated at 10% of vehicle price. From 1983 to the present FRET is calculated at 12% of the vehicle price.

Table 2 – Estimated FRET Payments 1981-1995

1. Opportunity Costs

Opportunity costs are a nebulous subject due to the nature of the Federal Government budgeting process, and the DOD Planning, Programming, and Budgeting System. In the case of FRET, opportunity costs were addressed in a 1983 study conducted by the TACOM Systems and Cost Analysis Directorate entitled, "Economic Analysis on the Cost to the Government of Imposing Federal Excise Tax on Army Vehicles." [Ref. 18] This study estimated the cost of the float, or actual dollar usage, tied up due to FRET, and compared it to the same cost in the private sector. It concluded that there was a 10-month more investment opportunity loss for the Army than for a comparable private sector truck manufacturer, as a result of Federal Excise Tax obligations. In effect, because the Army obligates the money upon contract award, and the contractor is not required to pay the tax until the vehicle is accepted by the Army,

significant dollars are tied up and unavailable for use by the Government for a significant period of time. The study concluded that for FY 82, the opportunity cost for the Army was $2.9 million, due to the lag in time between appropriation and contractor payment of FET to the IRS. Although this particular study has not been updated since 1983, due to significantly increased defense budgets for tactical vehicles since 1982, a valid assumption can be made that this figure has increased significantly.

In addition to actual monetary losses, other opportunity costs, with more direct impact to the soldier in the field, are identified below: [Ref. 49]

1. Continuance of the high maintenance cost for trucks manufactured during the late 1960s.

2. Delay in achieving capability increments identified as critical in 1991 during Desert Storm.

3. Delay in retiring older trucks, which fail to meet Federal Motor Vehicle Safety Standards (FMVSS). (Note: some of the vehicles to be replaced have the Army's poorest safety records)

4. Delay in replacing old trucks, which are heavy polluters not in compliance with Environmental Protection Agency (EPA) emission standards.

2. Record Keeping Costs

Although DOD contractors, as taxpayers, are liable for payment of FRET, and assuring accurate records are kept for IRS auditing purposes, history has proven that FRET payment is not that simple. As a result of pricing strategies employed by contractors when competing for Government contracts, and post contract award changes

by the Government, detailed record keeping is necessary, by both parties, to assure that the correct amount of FRET is paid on applicable vehicles produced under any given contract. These records serve to guide the parties when negotiating contract changes, but are also useful in assisting in disputes with the IRS. [Ref. 35] For example, accurate record keeping is critical to tracking the shipment of vehicles subject to FRET. The U.S. Army, by design, is a mobile force that, in its role of protecting American interests, is constantly changing to meet world events. Thus, it has a need for flexibility in meeting its materiel requirements. With long-term contracting arrangements, which are the norm for most large, complex system contracts, vehicle destinations are not usually known far enough in advance to assure accuracy when a multiyear contract is awarded. As a result, when preparing and awarding a contract, the Army estimates CONUS and OCONUS destinations, for evaluation purposes, knowing that changes will be necessary upon contract execution. [Ref. 47] This is just one area where after award actions by the Government are exacerbated by FRET issues that require unique records to address specific excise tax issues. Notwithstanding the pricing issues involved in these after award actions, the Army also uses its records to assist contractors in addressing IRS audit issues, where contract documents may not always match vehicle destinations. [Ref. Appendix B, para 9] Although difficult to quantify the actual cost of creating and maintaining these records, various contract specialists and contracting officers at TACOM indicate the time and effort is extensive.

3. Contract Management Costs

Contract management costs are another area where it is very difficult to quantify actual Government costs. Yet, unique efforts are required to specifically address FRET

issues. These efforts are necessary to assure proper contracting and financial regulations are followed, and the Government's best interests are protected. These costs are distinguishable from record keeping costs in that they involve actual additional actions required by contracting, resource management, legal, and other acquisition support personnel in managing contract performance. They include actions by contracting personnel when evaluating contractor proposals in response to Government change requests, such as preparation of negotiating positions that separately account for FRET impacts, and identifying fiscal year differences between program year vehicles to assure FRET funding is obligated appropriately. These costs also include preparing actual negotiation positions for calculating FRET, as the parties frequently disagree on the appropriate manner of calculating the application of FRET, especially on engineering change proposals (ECPs) that impact vehicle design, and result in additions and deletions to the original configuration. [Ref. 28, 29, 33, 35, 50]

In addition, Resource Management personnel are often required to separately fund FRET items, whether the result of incorporating ECPs into the contract, or in response to contractor requests for adjustment under cost reimbursement CLINs, as with the most recent Army wheeled vehicle contracts. This involves additional time and effort to justify and initiate separate funding documents. There are usually hundreds of CLINs on most Army system contracts. These are necessary to accurately account for different vehicle models, program year funding, line item pricing, ancillary equipment, and other unique attributes that require separate funding documents. The need to fund FRET separately to segregate costs to meet Government accounting and finance rules, or minimize administrative burdens, when making contract changes, is said to be time

consuming and burdensome by those working in the contract management process. [Ref. 13]

As indicated by the White Paper written in 1993 by Mr. John Klecha, legal advisor for Medium Tactical Truck programs, FRET issues have become very time-consuming for the legal community, as well. In addition to advising contracting personnel directly on handling FRET issues during the contract management phase of a program, TACOM lawyers spend additional time reading and interpreting tax laws and changes impacting FRET, in addition to lobbying other Government legal personnel in an effort to reach consensus on appropriate methods for addressing FRET in both 'pre' and 'post' contract award situations. Although contracting personnel, with the support and guidance of their legal representatives, have, "taken steps to limit the uncertainty associated with the acquisition of tax applicable vehicles...the treatment and the very nature of taxes included in offers on Government contracts is still a subject of divergent interpretation, which only adds to the complexity of tax applicable acquisitions." [Ref. 39] It is because of the continued uncertainty and complexity of FRET, as it applies to Government contracts, that legal personnel at TACOM are spending a significant amount of time addressing FRET issues during all phases of wheeled vehicle acquisition programs.

Although difficult to quantify, it is not difficult to assume that, due to ongoing FRET concerns on a variety of Tactical Wheeled Vehicle contracts, other contracting support personnel, from clerical support, to administrative staff, to supervisors and senior managers are also involved in the review and decision process necessary to address FRET issues. These staff positions also appear to spend time and effort supporting other

acquisition related personnel in addressing FRET issues, which takes time away from dealing with other important contract management issues.

4. Investigation and Audit Costs

As is evident from the history of FRET issues on various Army solicitations and contracts identified in Chapter III, the number and complexity of FRET concerns has resulted in numerous formal and informal audits and investigations over the last 20 years. An assumption can be made that some audits and investigations, either criminal or otherwise, that have findings regarding FRET, either directly or indirectly, would have occurred as a result of the usual DOD acquisition process, to assure integrity in the manner in which DOD agencies and organizations manage their contracting responsibilities. Equally valid, however, is the assumption that the vast majority of audits and investigations that specifically address FRET issues were commissioned to address FRET problems, perceived or not, directly. Although no specific information could be found in this regard, various Army procurement officials indicated that many of the audits conducted were requested to assist them in reaching informed decisions when addressing FRET issues. [Ref. 13, 28, 29, 35, 50] In addition, DOD Criminal Investigation Division (CID) agents and Justice Department officials, during the course of their investigations, have indicated that information initiating such investigations have come from various other Government and contractor personnel, who had reason to believe that FRET was being misapplied in certain contractual situations. [Ref. 28] In either case, there is a cost associated with these specific FRET investigations and audits that, although difficult to quantify, add some level of cost to the Army acquisition process.

5. Solicitation Preparation and Proposal Evaluation Costs

In an effort to address the many issues that seem to arise every time the Army procures Tactical Wheeled Vehicles that are subject to FRET, the tax is given special emphasis in the planning, solicitation, and evaluation phase of these programs, as is evidenced by the historical perspective provided in Chapters II and III. History indicates that this emphasis is intended to assure the Army pays the legally required amount of FRET, when buying FRET applicable vehicles from its contractors. It is also intended to simplify the accounting and payment process to avoid costly administrative effort in the FRET payment process, for both the Army and its contractors; and to minimize the possibility of FRET being a hidden or unintended factor in the source selection process. In any event, there is a cost associated with this emphasis, whether from the standpoint of the time spent addressing these issues, or the time not spent addressing other acquisition issues of equal or greater importance.

6. Negotiation and Litigation Costs

As with all large, complex DOD programs, negotiation efforts are usually extensive, time consuming, and complicated. In fact, many in the Government contracting field will tell you that DOD systems contracting consists of endless negotiations over new or changing contract requirements. [Ref. 13, 28, 29, 33, 35, 50] The researcher's personal experience in this regard would support such a conclusion. Rarely, in the course of administering a system contract, are the parties not negotiating some change or new addition to the contract. Thus, it is unusual in the course of contract administration to be able to work with your contractor counterparts in an environment completely devoid of animosity, or at least a difference of opinion, in any given situation.

This often hinders the parties from working together for mutual success. Because FRET, as applied to the Army acquisition process, has become a very complex portion of the system acquisition process, the contracting parties negotiating FRET issues consume many hours that could be spent addressing or negotiating other contract issues. In many cases, these same issues are then renegotiated due to differences with the IRS, once actual contractor payment occurs. [Ref. 48] The end result, despite the best intentions of the parties, is often protracted litigation that is time-consuming and costly for both the Government and the contractor.

C. THE COST OF FEDERAL RETAIL EXCISE TAX TO CONTRACTORS

In an effort to obtain independent data concerning the cost impact of FRET on DOD wheeled vehicle manufacturers, a survey was developed and forwarded to the top five Army wheeled vehicle contractors. These contractors were:

- AM General Corporation, South Bend, IN
- BMY Tactical Vehicle Division, York, PA
- Stewart & Stevenson Services, Inc., Houston, TX
- Freightliner Corporation, Portland, OR
- Oshkosh Truck Corporation, Oshkosh, WI

Due to ongoing Tactical Vehicle competitions and a fear of revealing competition sensitive information, several of these contractors requested anonymity for their responses. In addition, although three of the five contractors queried provided responses, only one of the contractors actually responded directly to the survey, and provided specific responses to each of the questions. The other two contractors provided significant information, but in their own format that did not necessarily correspond to the survey. Also, two of the contractors provided information from their external tax

consultants, and two provided input from their respective outside legal counsels. None were able or willing to divulge specific data on the actual cost of administering FRET. However, their responses, and the additional information they did provide, can serve to shed some light on the cost to our DOD contractors of administering the FRET statute, as currently written and enforced. To preserve the requested anonymity of two of the three respondents, and in an effort to categorize the responses of those contractors who chose not to respond directly to the survey, specific responses will be provided anonymously by using letter designators for each of the respondents, in no particular order (i.e., Contractor A, B, and C).

1. Impact on Pre-contract Bid or Proposal Strategy

To determine if contractors developed specific strategies in regard to FRET, when preparing pre-contract bids or proposals, the survey asked the following:

Does FRET have any impact, positive or negative, on your pre-contract actions/strategy (e.g., Proposal preparation time & effort, Bid strategy)?

Contractor A responded to this question by stating:

> In many proposal situations, (we) incurred cost in the way of added internal labor and professional fees related to excise tax. Issues not only arise in determining the excise tax due on each vehicle in a proposal, but also arise for every contract line item. Because of the complexity of the excise tax law, it is often unclear if excise tax is due on a certain vehicle. Additionally, in certain proposals, (we) felt excise tax was due on a vehicle and our competitors were unsure whether excise tax would be due. In this case, additional time and expense were incurred to get a private letter ruling from the Internal Revenue Service.

Contractor B did not respond directly to the question, but provided some insights, as follows:

> During the bid process, contractors make assumptions in balance against both the DOD and the IRS interpretations of FRET requirements.

> When those assumptions get cloudy, we (the contractor) rely on the contract provisions for coverage and protection.

Contractor B provided additional information in relation to this topic, as follows:

> Significant FRET administration costs are incurred directly by the Army and indirectly by its contractors as an element of cost in their proposals. Army direct costs are incurred for FRET specific contract planning and for payment administration (involving TACOM, DCMAO, and DCAA) once taxes are reimbursable to the contractor. Since FRET is a price based tax, the Government must maintain dual pricing (with and without tax) for all vehicle configurations to account for subsequent change order related price increases and for vehicles from an OCONUS to CONUS destination.

Although the contractors queried did not indicate any propensity to use the FRET statute as a part of an overall pre-award strategy, they did indicate that the handling of FRET in the proposal preparation process was time consuming and added additional expense to the process. Whether it be to obtain private letter rulings from the IRS, if deemed appropriate, or in making the effort to assure solicitation provisions did not contradict current IRS interpretations of FRET requirements, contractors are required to expend additional effort to assure compliance with FRET requirements, as they apply to the Army acquisition process.

2. Impact on Post-contract award Strategy

After contract award numerous administrative actions and bilateral changes are initiated to meet customer requirements, and to assure successful completion of the contract. To determine if FRET played a role for wheeled vehicle manufacturers during this phase of the system acquisition process, the following question was asked of the survey respondents:

Does FRET have any impact, positive or negative, on your post-award contract administration actions/cost/strategy (e.g., negotiation of contract changes, Supplemental Agreements, Change Orders, Unpriced Contractual Actions (UCAs), or vehicle delivery destination changes (i.e., CONUS vs. OCONUS and vice versa))?

Contractor A responded, as follows:

> Excise tax has considerable impact on the post-award contract for (us). The administration of excise tax for a contract is quite time consuming and sometimes very complicated. For each contract change, contract modification, excise tax must be considered. As discussed above, the answer is not always black and white for certain items. In these cases (our) outside excise tax advisors, and the government must come to an understanding on the excise tax ramifications of the contract change. Vehicle delivery has been a very large issue for (us) in regard to excise tax. The issue arises when vehicles that have been DD250'd (accepted by the government) and are not immediately shipped. In the past (we) have collected excise tax on the vehicles, which have a tentative CONUS destination and have not collected excise tax on vehicles, which have a tentative OCONUS destination. As the government changes the shipping instructions from CONUS to OCONUS or vise versa the tax administrative work related to excise tax becomes an issue.

Contractor B addressed this issue in the following manner:

> The estimated indirect FRET tax costs to be incurred by the contractor (subsequently passed to the Army) for the (multiyear wheeled vehicle contract) exceed $1.5 million over the five-year program life. In addition to those costs mentioned above, significant expense is anticipated in the IRS audit support, tax consulting oversight and tax library (sic) expenses. It can only be estimated that the Government, including the IRS, spends an amount at least equal to this for its FRET tax administration.

Contractor C provided a table laying out its estimated FRET tax liability under its current multiyear contract, as follows:

Fiscal Year	FRET Liability	Truck Quantity
1998	$ 187,838	10
1999	$12,505,482	545
2000	$14,776,176	770
2001	$ 8,722,156	382
2002	$10,137,692	477
2003	$ 7,578,947	332
Subtotal:	$53,908,291	2,516
Pricing Adjustment:	$ 114,257	
Contractor FRET:	$54,022,549	2,516

From the responses received, post-award impacts appear to be significant, when reviewing contractor responses to this question. Terms such as "considerable impact," "quite time consuming," "very complicated," and "significant expense" lead one to conclude that FRET when applied to DOD contracting is not a simple tax to administer by either the contractor, the Army, or the IRS.

3. FRET Versus Other Federal, State, and Local Taxes

To identify any unique aspects of FRET that might explain or put in perspective any additional administrative burden associated with the tax as opposed to other Federal, State, and local taxes; the following questions were asked of the respondents:

Is FRET treated like other Federal, State, and local taxes, as defined by FAR 52.229-3? If not, why not? If so, does FRET administration have a greater impact on cost and effort than other tax administration?

Contractor A responded:

> From (our) perspective, excise tax is treated like a sales tax. (We) collect and remit the tax.

Contractor B addressed the issue in this manner:

> FRET taxation has been open to numerous tax disputes – It costs the Army, Justice Department and the IRS thousands of man-hours to investigate, appeal, file motions and reach a final settlement. A recent case took five years to reach the initial decision, with an addition(al) three years of appeals, motions and settlement negotiations that ultimately went against the Army.
>
> Inclusion or Exclusion of Tax in the Bid – At least three different opinions exist between the IRS, GAO, and ASBCA for the proper handling of FRET in sealed bid acquisitions, further adding to the complexity of tax applicable acquisitions.
>
> The contractor is the taxpayer of record – Because of this "three party" arrangement, no feedback mechanism exists between the Army and the IRS to verify actual payments or for the Army to discuss and mitigate tax issues with the IRS.

Do Treasury Department (IRS), state, or local Government agencies conduct routine/regular audits to assess your company's tax liability? If so, are FRET audit requirements any different than other tax audits? If so, can you quantify the time/effort/documentation differences?

Contractor A responded:

> (We) are under continuous IRS audit for excise tax. FRET audit requirements are similar to other tax audits.
>
> IRS audits FRET on a regular basis along with (our) Federal Return.
>
> In the past, FRET had been audited on a regular basis…

A review of the answers provided by the respondents would indicate that FRET was similar to other excise taxes. However, when disputes arise, issues are complicated by differing interpretations of tax applicability amongst the various

Federal agencies and departments involved in these tax cases. From this perspective, it would appear that the unique aspect of the tax is not that FRET is necessarily different from other excise taxes, but that tax administration and payment is complicated when the customer is the US Army, or another Government agency.

4. The Cost to Administer

Contract administration is a critical aspect of successful contract completion for both the Government and the contractor. To determine the cost and time involved to administer FRET payment and issues that arise during the course of completing contract requirements, respondents were asked to address the following question:

Do you maintain a separate staff for the purpose of administering corporate tax liabilities? If so, is FRET handled by this staff or separately? In either case, can you segregate FRET administrative costs/effort? If so, do you have any quantifiable data for any period dating back to 1983 that you would be able to share concerning your overall FRET liability (either yearly or per contract) in relation to the value of Government contracts received, as well as your cost of administering the tax (on either an attribution or non-attribution basis)?

Contractor A responded:

> (We) have outsourced much of (our) tax compliance and consulting to an outside firm. However, with regard to excise tax compliance, quarterly tax returns, (we) use (our) regular corporate accounting department. For any excise tax consulting, (we) either use (our) tax-outsourcing firm or a law firm. It would be very difficult to segregate the administrative costs/effort for FRET due to the complexity and issues, which arise.
>
> Corporate Finance calculates/calls in bi-weekly payments and prepares the quarterly tax returns. We also research/solve any problems which generally relate to the defense segment. (A reputable accounting firm) assists (us) with any problems we find. On average, finance spends 3-4 hours per month on problems relating to FRET.

> (We) prepare FRET payments twice a month...via telephone. (We) also prepare quarterly FRET returns and internal audit schedules for the FRET liability.

It is difficult to draw any significant conclusions from the one response received. Yet, one could reasonably ask whether the outsourced tax compliance and consulting firm, and the outside legal counsel are necessary to address unique DOD FRET payment issues, or would these services also be necessary to address similar tax issues in a strictly commercial buyer-seller relationship? Although no cost data were provided by any of the surveyed contractors, the cost of engaging the services of these outside consultants is likely more than a nominal cost to the contractor, which is ultimately passed on to the Army in the price of vehicles.

5. Additional Comments: Costs and Benefits

In order to allow the contractors responding to the survey the opportunity to address any pertinent issue related to the FRET payment process, an additional question was asked that allowed the respondents to provide input that may not have been solicited, either directly or indirectly, in the previous survey questions. Thus, the following final question was posed, and responses provided, as indicated:

Do you have any additional comments or insights about FRET that you would like to share for the purpose of this research (on either an attribution or non-attribution basis)?

Contractor A responded:

> From a contractor's perspective, it seems like having the Government pay excise tax on vehicles, which it uses, is a type of cost accounting tax. The excise tax, which is collected by the contractor, is

remitted to the IRS who remits the tax to the Department of Treasury. The same Department of Treasury is the one who originally paid the tax to the contractor.

For Defense vehicles that have FRET included within the selling price, (we), as a defense contractor, collect FRET from the customer (TACOM) and in return pay (within an approximate two week timeframe) the original FRET amount to the IRS via estimated payments. All monetary sources originate and return to the Treasury Department of the United States.

Contractor B provided additional information that is more directly correlated to Government costs than contractor costs. However, the information is germane to the topic at hand, and provides additional insight into the complexity of the FRET issue, and is therefore cited as follows:

Cost/Benefit Disparity – According to available data, the Army is over funding FRET revenues (based on highway usage) by a factor of 23 times versus commercial operators. According to TACOM Fleet Management Data, its heavy trucks (exceeding 33,000 lb.) average 3,492 annual miles, equating to 71,940 lifetime miles over an average 20.6 year life. According to TACOM, approximately 35% of (those mileages) are driven over Federal Highways with the balance driven over Army maintained roads or in off-highway conditions. This equates to 25,180 (71,940 X 35%) lifetime miles over Federal Highways. By contrast, the 1987 Census of Transportation determined the average lifetime mileage of a typical commercial Class 8 truck is 295,120 miles, essentially all over Federal Highways.

To partially offset this disparity, commercial operators are required to pay an annual "Use Tax" (average $.01 per mile or $2,951 lifetime) in addition to the original FRET. Even with this additional tax there is still a significant disparity in favor of commercial operators. Using the above mileage, average price for a...(military) Cargo and Commercial Class 8 truck ($150,000 and $100,000 respectively), factoring the Use Tax and applying a present value factor of 6.1 to compensate for the longer military truck life, the tax disparity is as follows:

Vehicle	Average Price	FRET @ 12%	Use Tax @ 1%	Total Tax	Fed Hwy Miles	Tax Per Hwy Mile	Per Mile @ .61 NPV
Gov't	$150k	$18k	N/A	$18k	25,180	$ .71	$ 1.16
Commercial	$100k	$12k	$2,951	$14.9k	295,120	$ .05	$ .05

Table 3 – Government & Commercial Tax Disparity

Double Payment – In addition to (the) FRET disparity, the Army also pays 100% of the construction and maintenance of its own road systems from its Operations and Maintenance Funding (OMA). These roads are located on the various camps, posts, and stations. While total Army road miles is not known, the size of many posts is very large and would indicate an extensive road infra-structure, as indicated by the following examples:

Fort Benning, GA (182,000 acres), Fort Bliss, TX (1,200,000 acres), Fort Sill, OK (94,220 acres), Fort Lewis, WA (86,176 acres)

Commercial vehicles…travel virtually all their miles on publicly owned and maintained roadways. That is they use the very roadways that FRET as a highway-usage tax is designed to target. (In addition they) travel an exceptionally high number of miles each year. The US Department of Transportation's "Pocket Guide to Transportation" contains data, which…in 1998…notes that there were 1,741,854 combination trucks in the United States…which traveled a total of 118,8000,000,000 miles…for an average of 68,203 miles each.

Army tactical trucks tend to accumulate very few miles as compared to their commercially operated counterparts. (T)he M939 series averaged just 2,352 miles per truck…This is in comparison to the more than 68,000 miles per truck for commercial vehicles. (Most military trucks) have an expected Economic Useful Life of twenty years. This means that (these vehicles) will travel on average…47,040 miles during (their) 20 year service life. Said another way; (these military vehicles) will on average accumulate, in (their) entire service life, fewer miles than (their) commercial highway counterpart does in a single year.

(In addition), (t)here are many differences in design and usage of military vehicles as compared to commercial vehicles, which tend to make for much more expensive and heavier military vehicles. Characteristics significantly affecting weight and cost (are): High mobility, High reliability, Automatic transmission, Helicopter lift, Airdrop, Lift provisions, Self-recovery winches, Central Tire Inflation System (CTIS), Chemical Agent Resistant Coating (CARC) paint, Corrosion prevention measures, Deep water fording, Extreme temperature operations, Test

requirements, (and) low volume production.

From the additional comments received in response to this final survey question, it is apparent that contractors required to charge the Army FRET, and subsequently pay it to the IRS, have some significant concerns regarding the efficiency and legitimacy of FRET applicability to vehicles purchased by the Army. In addition to Contractor A questioning the efficiency of FRET payment by the Army, because the money originates from and ultimately returns to the Treasury Department; Contractor B makes an argument against the tax by laying out a case that the Army is paying a disproportionate share of the overall tax burden due to the minimal use of the national highway system by its Tactical Wheeled Vehicle fleet, as compared to a commercial truck fleet. Both of these issues are worth exploring when considering the FRET issue, as it pertains to the purchase of Medium and Heavy Tactical Wheeled Vehicles by the Army.

D. THE COST OF FEDERAL RETAIL EXCISE TAX TO THE US TAXPAYER

FRET in many ways is a zero sum game for the US Taxpayer. Depending on the manner in which Congress appropriates the nation's tax dollars, monies can go to either the Federal Highway Trust Fund or into the DOD budget toward our nation's defense. Requiring the military, in the course of purchasing Medium and Heavy Tactical Wheeled Vehicles, to pay into the Highway Trust fund through the payment of FRET to its wheeled vehicle manufacturers, who in-turn pay the IRS, is one method of allocating the nation's budget to serve the Taxpayer. Thus, this particular form of tax allocation does not harm individual Taxpayers, depending on their particular political bent. However, if, in the course of allocating monies in this fashion, significant inefficiencies exist, the US

Taxpayer does pay a cost as a result of these process inefficiencies. This will be explored more fully in Chapter V.

E. SUMMARY

This chapter provided an overview of the Army's Tactical Wheeled Vehicle fleet and its annual cost to operate and support. It identified the cost to the Army of paying FRET when procuring new and replacement vehicles. In addition to the actual tax itself, these costs include; opportunity costs, record keeping costs, contract management costs, investigation and audit costs, solicitation preparation and proposal evaluation costs, and negotiation and litigation costs. This chapter also addressed the cost of FRET to DOD contractors, who produce wheeled vehicles for the Army and other Services. It summarized the results of a survey of the Army's top five vehicle manufacturers, and elicited some information about DOD contractor FRET costs. Finally, the chapter addressed the potential cost to the US taxpayer of collecting the tax in its current form.

Chapter V provides an analysis of the statute, its impact on the Army's Tactical Wheeled Vehicle budget, and the cost of implementation by defense contractors. In addition, it analyzes the cost to the taxpayer of the current FRET payment process.

V. ANALYSIS OF FEDERAL RETAIL EXCISE TAX IMPLEMENTATION

A. INTRODUCTION

As delineated in Chapters II, III, and IV, the payment of excise taxes by the Army, specifically FRET, can be a cumbersome and resource-consuming process. The evidence indicates the issue is complex, even though FRET, in the most general sense, is simply a tax included in the price of Tactical Wheeled Vehicles sold to DOD, and paid to the IRS by manufacturers.

FRET contributions toward the Federal Highway Trust Fund serve to build, maintain, and preserve the Federal highway system, which, arguably, serves the public good by providing ease of transport for people, goods, and services, nation-wide. Thus, when analyzing the issues associated with the inclusion of FRET in the price of vehicles purchased by DOD, in conjunction with the role FRET plays in supporting the Highway Trust Fund, one must consider whether the overall national interest is being served when reviewing tax applicability and the payment process. Perhaps the best case for addressing the FRET issue was made in 1944, when the Government began taxing applicable goods and services sold to it through excise taxes. At the time, President Roosevelt, who had requested this legislative change, indicated it was warranted because the time and expense consumed in satisfying the administrative requirements for exemption had become more burdensome than actually paying the tax. The analysis that follows takes another look at the issue, in an effort to weigh these burdens against the benefits gained by having DOD pay this tax on the purchase of its Tactical Wheeled Vehicle fleet.

To begin, a review of the manner in which the Highway Trust Fund receives and distributes its funding is provided: [Ref. 26]

> The Federal Highway Trust Fund (HTF) was established on 1 July 1956 to receive the proceeds of Federal highway-user taxes and to serve as the source of funds for the Federal-aid highway program....
>
> Funds for the principal Federal-aid highway programs—the National Highway System, Interstate, the Surface Transportation program, the I-highway Bridge Replacement and Rehabilitation Program, Interstate Maintenance, Congestion Mitigation and Air Quality Improvement Program, Highway Safety, and Planning—are apportioned among the States using formulas or percentages found in Title 23, United States Code.... These formulas are intended to distribute funds so as to support the national interest in surface transportation. Generally, these apportionments are made without regard to the source of the funds and result in some States receiving less than the highway users in the State contributed while other States receive more. That is, some States are "donors" and some are "donees."
>
> The apportionments and allocations to each State from the Fund are easily obtained from the records of the U.S. Department of Transportation (DOT). It is a surprise to many (although not to some within DOD) that the contributions to the Fund are not similarly available from the Internal Revenue Service (IRS). The fuel taxes, which make up over 80 percent of the Fund's receipts, are imposed when the fuel is first removed from bulk storage and the tax is paid by the seller. Thus, the typical federal taxpayer is the oil company.... The truck tire tax receipts are concentrated in Ohio, the home of the U.S. tire industry, and the tax on truck and trailer chassis (FRET) is paid by the seller. Naturally, the costs of these taxes become part of the purchase price of the products and are ultimately paid by the highway user (in the case of DOD it is the military Services, and in the vast majority of cases that is the Army)....
>
> As tax records do not yield the desired information, the FHWA (Federal Highway Administration) estimates the Trust Fund contributions from highway users in each State. The method for attributing Trust Fund receipts to each State has changed over time. When FHWA first started making the estimates, it was in response to general interest in donor-donee issues. With the passage of the Surface Transportation Assistance Act of 1982, the attribution of Trust Fund receipts became a factor in calculating the 8.5-percent minimum allocation. FHWA...modified it to reflect the

> concerns of the States and the Congress that the attribution employ use-based factors. The resulting methodology...(has) been in use since that time.
>
> The Department of the Treasury reports the tax receipts deposited in the Trust Fund for each tax type. The net receipts, after refunds and transfers, are the contributions to the Trust Fund that are attributed to the highway users in each State.... The truck taxes—the truck and trailer chassis sales tax, the truck tire tax, and the heavy vehicle use tax—are attributed to the States using highway use of diesel and special fuels. This is considered to be the best available proxy for truck use in each State....

As can be seen by the above excerpt, the Federal Highway Trust Fund is an important National asset that is designed to provide continuing resources to assure upkeep of the national highway system. Eighty percent of the revenue for the HTF is generated by fuel taxes, with the remaining 20 percent distributed between highway use taxes (which Federal agencies, such as the Army, are not required to pay); truck and trailer tire taxes; and taxes on the sale of trucks and trailers meeting certain weight requirements (FRET). [Ref. 26] When considering the many factors involved in determining when, where, and how the various taxes supporting the HTF are collected; the complex formulas and percentage calculations used to determine allocation of fund assets between the States; and the relatively small contribution made by DOD to the fund, in the form of FRET payments to its contractors; an argument could be made that the contributions made by DOD are not worth the resultant impact of reduced military purchasing power, and the administrative burden of paying the tax. As indicated in Chapter IV, FRET is a significant cost to the Army and, to a lesser degree, other Services. It has a direct impact on the Army's procurement budget, and its ability to procure Tactical Wheeled Vehicles, necessary to meet mission requirements. It also impacts the Army's "cost of doing business," by adding administrative burden to the procurement

process in areas such as lost opportunity costs, record keeping costs, contract management costs, investigation and audit costs, solicitation preparation and proposal evaluation costs, and negotiation and litigation costs. However, an assessment, of all the issues surrounding the DOD payment of FRET to its wheeled vehicle manufacturers, is necessary before drawing any conclusions.

B. FRET IMPACT ON PRE-CONTRACT ACTIONS

Due to historical difficulties in assuring contractors include the appropriate amount of FRET in the price of vehicles sold to DOD, the Army expends much effort during the pre-contract phase of its acquisitions to assure that its solicitations are written in a manner that avoid both pre and post award tax issues. Despite these efforts, FRET issues continue to surface in the course of the acquisition process. An assessment of these pre-award tax issues indicates that efforts to supplement the existing tax statute and FAR provisions with additional Command level clauses, in order to avoid confusion and misrepresentation by offerors, are not working as intended. Although the Army's purpose is to clarify and emphasize the tax statute and FAR provisions in an effort to avoid misunderstandings and "gaming," during the pre-award phase of its wheeled vehicle acquisitions, the result has been that the Army serves to substitute its interpretation of the statute for that of its contractors and the IRS. As a result, even if its contractors agree with the Army interpretation, as ultimately defined in the solicitation clauses, issues arise when a successful contractor actually begins paying the tax to the IRS, under the resultant contract. Should the IRS disagree with the manner in which the contractor is making payment, or the amount being paid, the contractor must then resolve disagreements with the IRS before addressing the issue with the Army. This usually

takes the form of an REA from the contractor, should the IRS require tax payments in excess of the contractually stipulated FRET payment provisions. The result has been significant and costly pre-contract effort on behalf of Army and contractor procurement personnel, and their respective support staff of tax consultants and legal advisors, with no appreciable reduction in post-award FRET issues.

Perhaps better coordination between the Army and its contractors prior to the release of solicitations would assist in mitigating post-contract FRET payment issues. Of course, this would be easier in sole-source scenarios than for competitive acquisitions, but recent acquisition reform initiatives now encourage open communication between the Government and its contractors, even in competitive situations. Perhaps highlighting and seeking comments on specific FRET clauses in draft solicitations would be one manner of getting input and potential agreement before the parties enter into a contractual relationship. Since DOD contractors, as taxpayers of record, presumably have a closer relationship with the IRS than the Army, their input into the manner in which a given solicitation requires FRET payment could be invaluable in avoiding post-award tax issues. There is still the matter of the IRS, the ultimate decision-maker on tax issues, interpreting the payment process in the same manner as the Army and the contractor, but chances of agreement would appear to increase if at least the contracting parties agreed up front on how FRET should be calculated and paid.

C. FRET IMPACT ON POST-CONTRACT ACTIONS

In the post-award arena, FRET has entailed even more significant cost and effort on the part of the Army and its contractors in terms of addressing the inevitable contractual conflicts that have arisen over the last 20 years on every major Tactical

Wheeled Vehicle program. As was discussed in Chapter IV, there are a myriad of explanations for ongoing conflict between the Army, its contractors, and the IRS when it comes to FRET payment issues under DOD contracts. These include post-contract tax statute changes, vehicle destination changes, and the incorporation of ECPs and other revisions into contracts, to name just a few. The result has been additional audits and negotiations, depending on the importance and cost impact of a given change. Significant investigation and litigation time, effort, and costs are also incurred when the parties reach an impasse in the contract change process, or the parties have determined that one or the other has not complied with either the contract terms and conditions or the law. Of course, if contracts were never changed after award, disagreements over the impact of these changes to FRET would be eliminated. This would not eliminate all FRET issues, however, as there would still be potential conflicts occasioned by disagreements over the contract, as originally written. It would, however, greatly reduce the number of FRET issues facing the contracting parties. Nonetheless, such a scenario is unrealistic when considering the nature of writing contractual instruments in general, and the need to create and administer living documents to support the changing circumstances of any contractual relationship. This is especially true in the dynamic DOD acquisition environment, where flexibility and change are a requirement, if the DOD contracting mission is going to adequately support the needs of the Military.

An assessment of the post-award FRET issues identified in Chapter III would indicate a significant disconnect between the contracting parties themselves and the IRS, when it comes to interpreting and implementing the FRET statute in accordance with FAR guidelines and provisions. An analysis indicates that the more the Army attempts to

clarify current tax provisions, the more there appears to be a potential for disagreement and misunderstanding after contract award. Yet, some mechanism must exist that allows both parties to comply with the FRET statute in accordance with IRS regulations, while avoiding the inevitable conflicts that have arisen over the last 20 years.

One option that does not appear to have been attempted by TACOM, to date, is for the Government to sit down with the winning contractor shortly after contract award, such as at the post-award conference, to identify how FRET will be handled, both initially, and when making contract changes. Any agreement could then be documented in the form of a Memorandum of Agreement (MOA) or an Advance Agreement, whereby the parties have determined how FRET issues will be addressed, and also identify the procedure for processing potential disagreements. With today's emphasis on partnering between the Government and its contractors, this type of agreement could either be a stand-alone document, or incorporated into whatever partnering arrangement exists between the parties.

Another option might be for the contracting parties to meet with IRS representatives together, in an effort to project a united front, and work to identify and simplify the FRET payment process on behalf of the contractor. This could potentially serve a two-fold purpose. First, it could help to identify and resolve overly cumbersome payment issues between the IRS and the contractor. Secondly, it could bolster the partnering process, by having the Army support the contractor in its effort to work more closely with the IRS, to address FRET payment issues.

D. DOD AND ARMY FRET POLICY

As stated in Chapter II, the FAR requires that all DOD contracts contain a provision for the payment of applicable Federal, State, and local taxes by its contractors. By virtue of this and other provisions required in DOD solicitations and contracts, it can be assumed that contracts for Medium and Heavy Tactical Wheeled Vehicles contain the appropriate FRET for applicable vehicles. However, as a result of the diversity and complexity of items contained in large vehicle system contracts, and the changes necessary to meet user requirements, during the course of administering these contracts; the accurate payment of these taxes, especially FRET, has often-times been a source of dispute between the Army, the largest purchaser of these types of vehicles for DOD, and its contractors. The subsequent policy and supplemental clause revisions implemented by the Army, via its automotive procurement command, TACOM, have accomplished little by way of clarifying or minimizing FRET issues on solicitations and contracts for its Medium and Heavy Tactical Wheeled Vehicle fleet, as indicated by the historical perspective provided in Chapter III. An analysis of those ancillary and administrative actions the Army takes to assure compliance by it and its contractors may assist in addressing this question.

TACOM has implemented numerous policy changes in the last 20 years, as a result of Congressional revisions to the FRET statute, and lessons learned by the Army and its contractors from previous mistakes and disagreements over tax implementation. It has moved from taking a hands-off approach and allowing its contractors to independently address their tax liabilities, to adding local clauses to supplement the FAR and further define contractor FRET, to forcing contractors to provide proof of FRET

payment before obligating funds under its contracts. Each of these changes was intended to avoid misunderstandings and misinterpretations between the Army, its contractors, and the IRS. Despite these efforts, FRET issues and disagreements continue to come at a high cost to the Army and its contractors, either directly, through increased or premature tax payments, or indirectly, through burdensome administrative effort.

In evaluating this situation, it is readily apparent that attempts to simplify or standardize FRET payment policy by the Army alone have been unsuccessful. In addition, efforts to exempt the Army from payment of the tax altogether have led to failure at either the DOD, Secretary of the Treasury, or Congressional level. In light of this failed history in regard to the Army's efforts to minimize or eliminate the FRET administrative burden for itself and its contractors, other alternatives must be considered.

One such alternative takes advantage of recent acquisition reform initiatives within DOD, and recent legislation regarding reforms within the IRS, to attempt to get both agencies to work in concert with wheeled vehicle manufacturers to establish bi-agency policies that simplify the FRET payment process for both the Army and its contractors. In this scenario, as a result of the contractor being the "taxpayer of record," such an effort would probably require Army contractors to work together and take the lead to initiate serious communication and cooperation between these Federal agencies and themselves. In all likelihood, this would be a difficult, if not impossible, task. On the other hand, attempting such an "agency summit" could serve as a true litmus test for the success of recent Government reform initiatives.

Another alternative calls for the Army to coordinate with its sister Services or other Government agencies to compare notes on policies concerning payments of any

kind from one Government agency to another. Since the Army is the component agency within DOD for the procurement of wheeled vehicles, it is unlikely that the FRET issue would be well known to the other Services. However, there may be similar agency-to-agency payments, currently unknown to the Army that could serve to provide insight or guidance on simplifying the FRET payment process. Even non-DOD agencies, such as the General Services Administration (GSA), may provide information on excise tax payments, since it also procures vehicles that use the Federal highway system, and that may be large enough to meet statutory FRET requirements.

E. FRET COST TO THE ARMY

The cost of FRET to the Army, as stated in Chapter IV, can be categorized as both direct and indirect. This direct cost is the actual amount of FRET paid by the Army to its contractors, which is approximately 12 percent of the price of vehicles exceeding certain weight requirements. Contractors then pay this excise tax to the IRS in accordance with statutory requirements. Indirect costs are those costs related to the payment of FRET, and include lost opportunity costs, record keeping costs, contract management costs, investigation and audit costs, solicitation preparation and proposal evaluation costs, and negotiation and litigation costs. Yet, projecting the amount of FRET to be paid by the Army for applicable vehicles in its Medium and Heavy Tactical Wheeled Vehicle fleet is difficult, due to the many variables that determine FRET applicability in any given situation. Variables such as weight, and CONUS versus OCONUS delivery destination must be considered when attempting to budget for this direct cost. Given these constraints, the Army has projected that it will spend approximately $150.7M in FRET on its FMTV fleet from FY 1999 through FY 2005. A conservative estimate of the

indirect costs associated with FRET payment for this program over the same time period would likely be five percent of the direct cost (or approximately $7.5M), when considering the number and variety of personnel involved in administering and monitoring FRET issues and payments during the entire acquisition process.

When evaluating these numbers, it is difficult to avoid questioning both the rationale for Army payment of the tax, and the amount of tax paid, as compared to private sector customers who are purchasing FRET applicable vehicles specifically for use on the Federal Highway System. For example, a rough estimate of the amount of tax paid by the Army, through its contractors to the IRS, from 1981 to 1995 is $632 million on $5.6 billion worth of Tactical Wheeled Vehicle procurements. In accordance with the FRET statute, this money ultimately served to fund the HTF. At the same time, TACOM Fleet Management data indicate that Medium and Heavy Tactical Wheeled Vehicles average 3,492 annual miles, equating to 71,490 lifetime miles over an average 20.6 year life. Approximately 35 percent of its lifetime miles are driven on Federal highways (71,490 X 35% = 25,022 miles), with the balance driven over Army maintained roads or in off-highway conditions. This, as opposed to 1987 Census of Transportation data that indicate the average lifetime mileage of a typical commercial Class 8 truck is 295,120 miles, the vast majority of which are over Federal highways. Thus, a case could be made that this significant direct cost to the Army, in the form of the FRET tax, is disproportionate to the amount of miles military vehicles spend on Federal highways, compared to equivalent commercial vehicles, when considering the method of tax determination, which is based on the selling price of the vehicle. It is also significantly higher than the rate per mile of taxes paid in the commercial sector. At the same time,

the Army spends 100 percent on the construction and maintenance of its own extensive infrastructure and road system, where military vehicles spend approximately 65 percent of their 3,492 annual miles.

The seemingly disproportionate amount of tax being paid by the Army, as compared to the actual road usage of its Medium and Heavy Tactical Vehicle fleet, is the result of the manner in which FRET is assessed. Under the current statute, FRET is a manufacturer's tax that is based solely on the selling price of a vehicle. An analysis of this disparity identifies a possible alternative that would save the Army millions of dollars per year, while more equitably allocating the FRET burden to both the Army and commercial truck purchasers. A "Use" tax would respond to the issue of fair allocation of the tax burden by levying the tax on a proportionate basis. As a result, those who actually use the Federal highways would pay based on actual mileage traveled.

F. FRET COST TO DEFENSE CONTRACTORS

Unlike the cost of FRET to the Army, the cost to defense contractors is based on collecting the tax in the price of its vehicles, and subsequent payment to the IRS. As such, the tax itself is a direct cost to the Army, and results in indirect costs to its contractors. Although an indirect cost, the administrative burden of processing this tax is significant and cumbersome, as indicated in the contractor responses to the survey identified in Chapter IV. In addition, miscalculating FRET in vehicle prices for competitive solicitations could make the difference between winning or losing a contract award, especially in the highly competitive Tactical Wheeled Vehicle market. Even in a sole-source environment, mistakes in calculating FRET can result in unnecessary controversy, either during the negotiation phase or contract administration phase of the

acquisition process. As a result, the handling of FRET by defense contractors in the proposal preparation stage of an acquisition program is taken very seriously, and contractor responses would indicate significant time is spent reviewing specific program requirements and solicitation provisions to assure themselves that corporate tax policies do not conflict with solicitation guidance concerning FRET. Even when satisfied that FRET issues do not exist, contractors must often be prepared to address tax issues after contract award, when payments to the IRS begin.

By having to incur the cost of added labor and professional fees to assure compliance with solicitation and, ultimately, contractual requirements, contractors expend additional time and money that could arguably be spent in more productive ways. In one sense, it could be reasonably stated that complying with the FRET law, as with any other Federal, State, or local tax, is the cost of doing business, and if overhead costs are not expended here they would be incurred in some other facet of business operations. Yet, when it comes to complying with DOD rules and regulations, the FRET payment process is unique when applied to the military contracting environment. As indicated in Chapters III and IV, the Army is constantly reassessing its needs to assure effective deployment to anywhere in the world at a moment's notice. As a result, it is not always capable of identifying vehicle destinations early enough to satisfy contractual requirements. It, therefore, must have the contractual flexibility to change delivery instructions between CONUS and OCONUS destinations. This and other contractual change options provide additional complexity to the tax burden that is rarely seen in a commercial environment.

When the inevitable disagreements do arise, whether between the contractor and the IRS, or the contractor and the Army, protracted negotiations are usually required before a given issue is resolved to the satisfaction of the contracting parties and the IRS. In fact, as evidenced by the historical perspective provided in Chapter III, it is not unusual for issues to result in REAs, claims, and even litigation before resolution can be effected to the satisfaction of all the parties. The situation is complicated by the lack of direct communication between the Army and the IRS on FRET matters. Thus, the contractor is often the conduit by which disagreements between these two Government agencies are ultimately resolved.

Even in this era of Acquisition Streamlining and Reform that promotes partnering between the Army and its contractors, FRET issues do not lend themselves to easy solutions. This is evidenced by the various opinions that exist between the IRS, GAO, ASBCA, and the Army, as to the proper handling of FRET in specific contractual situations. The result of these ongoing issues is that contractors must pay the cost of the added complexity of tax applicable DOD acquisitions, by maintaining a higher overhead, or contracting out for tax advice and legal services. In addition, contractors must be prepared to deal with and support numerous DOD audits and investigations, as well as regular IRS audits.

From the information provided by contractors to the FRET survey, it is apparent that DOD wheeled vehicle manufacturers have spent time and resources both internally, and in conjunction with outside consultants, to study the FRET statute. Presumably, these studies have been in response to FRET issues that have arisen in the course of contracting with DOD. Their purpose is to influence Congressional, DOD, and Treasury

Department action in a manner that addresses the FRET problems that have occurred over the last 20 years, and continue to occur between the Army and its contractors. With little noticeable action, to date, on the part of any of these agencies in response to these studies, perhaps the time has come to review different alternatives.

G. EXECUTIVE BRANCH ALTERNATIVES

The FRET statute as currently written exempts the following articles: Camper coach bodies for self-propelled mobile homes; Feed, seed, and fertilizer equipment; House trailers, Ambulances, hearses, etc.; Concrete mixers; Trash containers, etc.; and Rail trailers and rail vans. In addition, the statute authorizes the Secretary of the Treasury to exempt heavy trucks, as follows: [Ref. 55, 56]

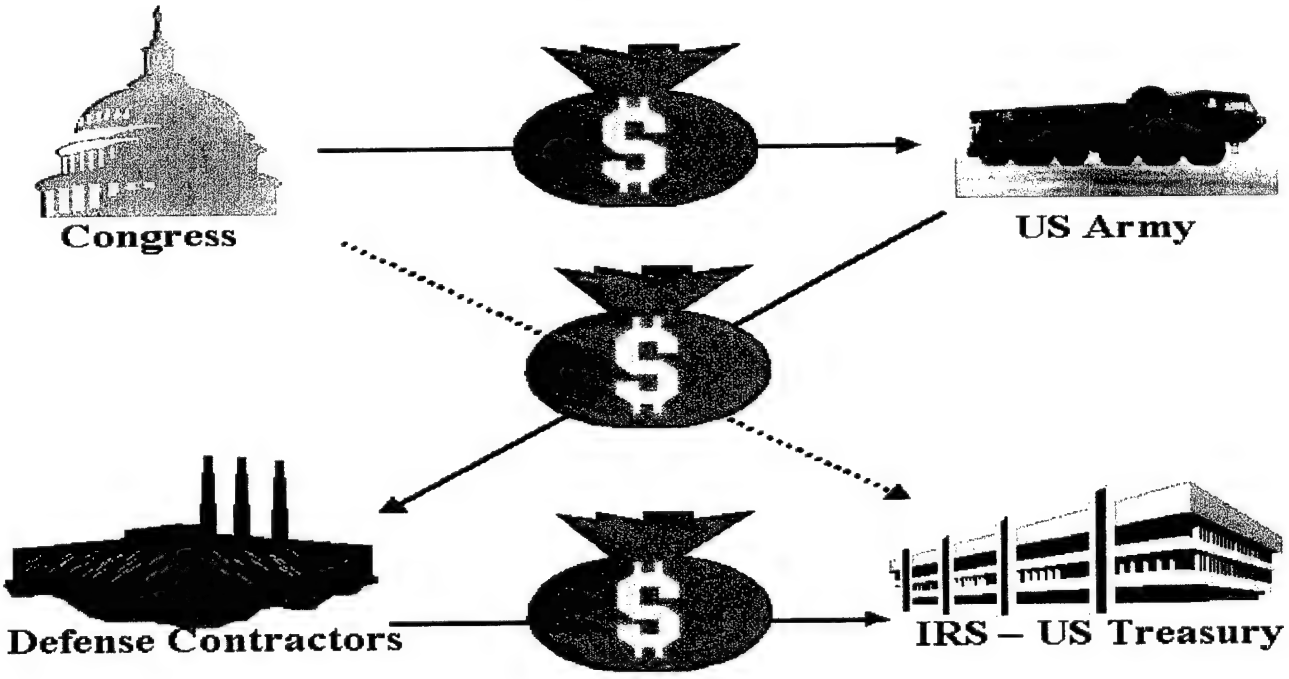
> The Secretary of the Treasury may authorize exemption from the excise taxes imposed on heavy trucks purchased for the exclusive use of the United States if he determines that the imposition of such taxes will cause a substantial burden or expense which can be avoided by granting tax exemption, and the full benefit of such exemption, if granted, will accrue to the United States.

Thus, the statute grants the Treasury Secretary broad latitude to exempt articles, including heavy trucks, from this excise tax. DOD requested such an exemption through the Office of Management and Budget (OMB) in the early 1990s, and has since reported on the FRET burden within DOD in periodic reports to Congress. However, the Treasury Department has yet to respond to this request by DOD. A defense contractor in its response to the FRET survey also noted the seeming incongruity of one Executive Branch Department taxing another through third party contractors, as follows:

> From a contractor's perspective, it seems like having the Government pay excise tax on vehicles, which it uses, is a type of cost accounting tax. The excise tax, which is collected by the contractor, is

remitted to the IRS who remits the tax to the Department of Treasury. The same Department of Treasury is the one who originally paid the tax to the contractor.

Thus, an analysis of the FRET issue within the Executive Branch must begin with a review of the efficiency of the current process. Figure 1 entitled, *Federal Retail Excise Tax*, graphically depicts this process, and presents one possible alternative.



Source: [Ref 14]

NOTE: The solid arrow lines in the above chart depict the current fund flow process. The dotted arrow line depicts one alternative that might more efficiently provide these tax revenues to the Federal Highway Trust Fund.

Figure 1 – Federal Retail Excise Tax (FRET) Flow

Figure 1 suggests an alternative that would eliminate the administrative burden on both DOD and its contractors, by having Congress appropriate HTF funding directly to the US Treasury. If FRET is ultimately a zero sum game for the US Taxpayer, then monies

collected by the Government can go to either the HTF, to fund Federal highway building and repair programs, or to DOD, to fund national defense programs. The issue for the Taxpayer then becomes one of how efficiently the Government collects and allocates these tax dollars.

Whether looking at the FRET statute from a funding, legal, common sense, good business practice, or political perspective; a case can be made regarding the inefficiency and ineffectiveness of one Executive agency taxing another through third party contractors. An economist might argue that any Government taxation program is inefficient by its very nature. Yet, any review of the role of Government in a democratic society must consider the benefit of tax policy as an effective tool for implementing public policy. In this case the question is not necessarily whether FRET is an efficient tax, but rather is DOD payment of FRET, when purchasing Tactical Wheeled Vehicles, an effective use of Government resources.

H. SUMMARY

This chapter provided an analysis of the FRET issue as it relates to the purchase of Tactical Wheeled Vehicles by DOD. By evaluating the issues from many different perspectives, a basis was established for assessing the cost to DOD in relation to the benefit to the Federal Highway Trust Fund. These costs were assessed from the following perspectives: FRET Impact on Pre-contract Actions, FRET Impact on Post-Contract Actions, DOD and Army FRET Policy, FRET Cost to the Army, FRET Cost to Defense Contractors, and Executive Branch Alternatives. The analysis provided comparisons and offered alternatives to the current FRET payment process by DOD.

Chapter VI will add perspective by drawing conclusions and making some recommendations based on the data presented.

VI. CONCLUSIONS AND RECOMMENDATIONS

A. INTRODUCTION

During the course of this thesis, an excise tax known as FRET was introduced. The tax is applicable to the sale of trucks weighing in excess of 33,000 pounds and trailers weighing greater than 26,000 pounds. For DOD, this means FRET must be included in the purchase price of its Medium and Heavy Tactical Wheeled Vehicle fleet. An historical perspective of FRET, as it applies to DOD, identified the Army as the major purchaser of Tactical Wheeled Vehicles within DOD. This history also indicates that in the course of FRET administration and payment, a myriad of issues consistently arise between the Army, its contractors, and the IRS. In analyzing these issues, significant direct and indirect costs were identified for the Army and its contractors during the course of the FRET payment process. The direct tax payments are ultimately a zero sum game for the American taxpayer, as one Government agency, the Army, is essentially transferring funding that has been previously authorized and appropriated by Congress to another Government agency, the IRS. It is the manner in which these payments are made, through the Army's wheeled vehicle manufacturers, that results in the imposition of significant indirect cost to both the Army and its contractors.

Both these direct and indirect costs impact the way the Army does business, and its ability to meet its mission in an efficient and effective manner. In the following paragraphs, I will assess the impact of the current FRET payment process, and draw some conclusions. Based on these conclusions, I will make recommendations for improving the FRET payment process within DOD.

B. CONCLUSIONS

Following are eight conclusions drawn from a review of the FRET statute and the Army's implementation of the statute. This includes an historical perspective of FRET issues and litigation, a look at the cost of FRET to the Army, its contractors, and the US taxpayer, and, finally, an analysis of FRET implementation within DOD.

1. FRET is unfairly levied against the DOD purchase of Medium and Heavy Tactical Wheeled Vehicles.

Information from the TACOM fleet planning office indicates that Army trucks exceeding 33,000 pounds GVW average 3,492 annual miles. Of these miles, 35 percent are driven over Federal highways. The balance of miles is driven on Army maintained roads and in off-highway conditions. This equates to 25,180 lifetime miles for Army vehicles on Federal highways, as the estimated average lifetime of these vehicles is 20.6 years. By contrast, the 1987 Census of Transportation determined that the average lifetime mileage of a typical commercial Class 8 truck is 295,120 miles, all of which are essentially spent on Federal highways. As indicated in an analysis conducted by one of the Army's wheeled vehicle manufacturers, this equates to a large disparity between the amount of FRET paid by the Army on its vehicles, as compared to Commercial fleet operators.

Because FRET operates similar to a sales tax, the Army is further disadvantaged by the high cost of military unique hardware required to be placed on its vehicles that are not necessary or useful for commercial vehicles. Attributes such as Helicopter and Airdrop lift provisions, Self-recovery winches, and a Central Tire Inflation System, to name a few, add cost and weight to vehicles that results in a tax liability disproportionate to commercial counterparts.

Consequently, the Army is required to use its scarce tactical vehicle budget dollars to administer and pay an excise tax that does not accurately reflect DOD vehicle usage of the Federal highway system, which the tax is intended to fund.

2. DOD pays a significant cost under the current FRET statute, both directly through actual FRET payment, and indirectly through the administrative burden to both the Army and its contractors.

The FRET statute requires vehicle manufacturers to include FRET in the price of applicable vehicles sold to the public. Although somewhat complicated by the exemption of certain vehicle components (e.g., tires), the payment of FRET is a straightforward matter. Payment involves collection (included in the vehicle price) and payment by the manufacturer (12 percent of vehicle price), less exempt components, calculated and paid to the IRS in accordance with a pre-determined schedule. However, when DOD becomes the customer, the manner of tax payment and the administrative burden to both the Army and its contractors becomes significantly more complicated.

An approximation of the direct cost of FRET to the Army from 1981 through 1995 is half a billion dollars for the replenishment of its Medium and Heavy Tactical Wheeled Vehicle fleet. Using the five percent figure established in Chapter V, to calculate the related Government indirect cost, generates an associated indirect cost impact of $25 million. Although the contractors responding to the FRET survey did not provide data specifically identifying actual FRET costs, it can be assumed that the indirect cost to Army wheeled vehicle manufacturers, to both administer and litigate FRET issues, were roughly equivalent to the Army's, during this same time period.

These costs would have ultimately been passed on to the Army in the price of its wheeled vehicles.

As a result of incomplete budget data on the various tactical wheeled programs, it is difficult to calculate the impact of FRET on future Medium and Heavy Tactical Wheeled Vehicle procurements. However, budget projections for the FMTV program indicate that the Army anticipated paying $150.7 million in FRET between FY 1999 and FY2005. This equates to an FMTV budget of approximately $1.255 billion during this timeframe. Even without complete budget data, it is anticipated that the Army will continue to spend significant defense dollars to update its Medium and Heavy Tactical Wheeled Vehicle fleet well into the next century. Although FMTV is currently planned as the cornerstone of this aging fleet replacement process, it is anticipated that several other tactical vehicle programs falling within FRET applicable weight requirements, will result in continued FRET payments far exceeding those currently identified for FMTV.

3. FRET has a major impact on the manner in which the Army procures its Medium and Heavy Tactical Wheeled Vehicle fleet.

As stated in the analysis in Chapter V, FRET has an impact on both pre-contract and post-contract actions by the Army. During the pre-contract phase, significant effort is expended by contracting personnel, tax experts, and legal advisors to review and tailor specific clauses for incorporation into its solicitations and subsequent contracts, to address past FRET problems between the Army and its contractors. These efforts are accomplished on a given vehicle program early in the acquisition process in order to avoid reliving past FRET problems. The Army accomplishes this by including applicable FAR clauses, which require the inclusion of all applicable Federal, State, and local taxes

in the price of the vehicles it buys. In addition, TACOM supplements these FAR provisions with Command level clauses. These clauses identify the manner in which these taxes are to be calculated and paid, in an effort to ease the administrative burden to both the Army and its contractors, and to assure the accurate payment of the tax to the IRS.

In the post-award phase, the evidence indicates that despite the Army's efforts, contractual conflicts have arisen over FRET issues on every major Medium and Heavy Tactical Wheeled Vehicle program in the last 20 years. Consequently, the Army is continuously expending resources to eliminate potential ambiguities and confusion between itself and its contractors to minimize the impact of FRET on the administration of its contracts. Despite these efforts, FRET issues continue to arise between the Army, its contractors, and the IRS. This results in additional audits, negotiations, and investigations. It also leads to the submission of REAs and claims by contractors, and in the worst cases, the outcome is extensive litigation. In many cases, FRET issues arise after contract award because of the flexibility required by the Army to assure the soldier receives the right item, at the right time and place. This often results in the need to make delivery changes, often between CONUS and OCONUS destinations, and to make configuration changes in the form of ECPs. Both of these contract changes impact the applicability of FRET to vehicle prices, and, therefore, require action on the part of the Army and the contractor to re-negotiate vehicle prices, including the tax. As a consequence, the Army is continuously seeking new and better ways of dealing with FRET when procuring Medium and Heavy Tactical Wheeled Vehicles. This results in significant time and effort on an issue that provides no value added to the final product.

4. FRET increases the cost to defense contractors of doing business with DOD.

In accordance with the FRET statute, defense contractors are required to collect the tax in the price of vehicles sold to DOD. Contractors than pay the tax to the IRS in a mutually agreed upon manner. As a result of the complexity of the tax statute and additional FRET payment guidance provided by the Army in its solicitations and contracts, defense contractors spend considerable time and effort determining the excise tax due on each vehicle and contract line item, when bidding on Government contracts. Often times this requires contractors to supplement their internal tax department with outside tax and legal expertise, thereby adding to the cost of doing business.

According to these contractors, issues frequently arise during the solicitation phase of a given program, when they are evaluating their strategy and determining when and how the tax is applied. It is during this phase of the acquisition process that contractors make assumptions and attempt to balance both DOD and IRS interpretations of the FRET requirements.

Subsequent to contract award, contractors are often caught between the Army, and its ability to effect contractor payment through implementation of contract terms and conditions; and the IRS, which demands payment in accordance with the FRET statute, whether or not the Army has funded FRET payment to its contractors. As a result, contractors incur significant administrative costs to track excise tax payments, both from the Army and to the IRS. This is frequently due to the complexity of tracking tax applicability that results from shipping instruction and other contract changes. For each contract change, excise tax must be considered, and the issues are not always easily

categorized. In many cases, the contractor and the Government must agree on the tax implications for a particular change, and the contractor must then justify the agreement to the IRS. Ultimately, the contractor is then subject to the usual audit mechanisms used by the IRS to assure the proper payment of the tax. In addition, DOD audits and inspections are necessary to assure that all applicable laws and regulations are being met, when contractors sell items to DOD. This includes FRET payment.

As a result of the many contract changes and audit requirements that are unique to DOD contracting, the FRET payment process is more complex when contractors are conducting business with DOD than in a commercial environment. This complexity adds cost to both DOD, by way of the price it pays for its vehicles, and the contractor in terms of the significant expenses it must bear in administering this FRET burden.

5. FRET will be a determining factor in the future size and capability of the Army's Medium and Heavy Tactical Wheeled Vehicle fleet.

As was indicated in a 1983 TACOM Systems and Cost Analysis Directorate economic analysis on the impact to the Army of paying FRET, there are significant opportunity costs associated with this tax on Army vehicles. Those most directly impacting the soldier in the field include the continuance of high maintenance costs for older trucks currently in the field, a delay in achieving capability enhancements identified as critical in 1991 during Desert Storm, and a delay in retiring older trucks that fail to meet Federal Motor Vehicle safety standards and EPA emission standards. As delineated in Chapter IV, in addition to opportunity losses, there are also several other indirect costs that impact the price of replacement vehicles for the Army's aging Tactical Vehicle fleet. These include record keeping costs, contract management costs, investigation and audit

costs, solicitation preparation costs, and negotiation and litigation costs. All of which serve to increase the price of these replacement vehicles to the Army, and the other Services, at a time of shrinking defense budgets. Thus, the Services must reduce their expectations regarding the number of replacement vehicles they can procure within foreseeable defense budgets for Tactical Vehicles. In this regard, FRET will continue to be a distinct factor in determining the cost, and ultimately the size of the replacement fleet, through the impact of the tax on the price of these vehicles.

6. A complicating factor in determining FRET applicability is whether the final vehicle destination will be CONUS or OCONUS.

As explained earlier in this thesis, FRET is not applicable to vehicles shipped outside the continental United States. As a global force dedicated to protecting the interests of the United States, wherever they may be in the world, the Army has units throughout the world. As such, replenishment supplies and equipment, including Tactical Vehicles, are provided to these units, wherever they may be located. However, due to the changing tactical, economic, and political environment at any given point in time, Army units often change location long before contract vehicles are scheduled for delivery under the terms of a given contract. This is especially true in the case of multiyear contracts, where delivery locations are projected for solicitation evaluation purposes as much as five years in advance of actual deliveries.

It is therefore common practice for Government acquisition personnel, when identifying vehicle delivery destinations, to estimate the number of vehicles to be shipped CONUS and OCONUS for the purpose of determining Government transportation costs in the evaluation of contractor offers. As a result, the Government must also estimate the

number of vehicles with and without FRET applicability, and identify them in the solicitation document. This allows contractors to bid on vehicles with FRET included for CONUS deliveries and without FRET for OCONUS deliveries.

The manner in which the Army denotes these vehicles in the solicitation is intended to simplify shipping changes after contract award. By identifying vehicle prices for any given model, inclusive and exclusive of the tax, the Army allows itself the flexibility to administratively change vehicle destinations within a reasonable time before vehicle shipment, but after contract award. However, as a result of contractor pricing strategies in competitive environments, and complex costing strategies in sole-source scenarios, the Army's efforts at simplification rarely work once a contract has been executed.

The result is often protracted discussions and negotiations over the manner in which the Army can effect such a change and many debates over the impact of the destination change(s) on the amount of FRET included in vehicle prices. Consequently, the current process of identifying CONUS and OCONUS vehicles in the Army's contract instruments does not work and often leaves the contracting parties at odds before they ship a single vehicle under the terms of a given contract.

7. FRET will have a detrimental impact on Army Tactical Vehicle overhaul programs.

In an effort to maximize scarce program dollars in today's downsizing environment, and to maximize the potential for replacing an aging fleet, the Army is currently reviewing options to remanufacture some of its critical tactical vehicle systems. The purpose of these programs is to save time and money by overhauling vehicles to a

"like new" condition, at a portion of the cost and time to procure new vehicles. However, the FRET statute requires the imposition of the tax on rebuilt and remanufactured vehicles, if the cost of such repairs exceeds 75 percent of the retail price of a comparable new article.

Under this scenario, program offices are encouraged to look at ways of maximizing capability improvements of older vehicles, while simultaneously attempting to keep costs artificially below the 75 percent threshold to avoid a 12 percent surcharge in the form of FRET. Thus, engineering decisions are very likely being influenced during the planning stages of these overhaul programs, in an effort to avoid this extra 12 percent cost. In fact, the tax could easily become the deciding factor in an analysis of the costs and benefits of purchasing new vehicles, as opposed to the overhaul of existing vehicles. A likely outcome of this dichotomous situation, as program offices attempt to preserve scarce dollars, is the design of rebuild and remanufacture programs such that desired upgrades are limited to stay within this 75 percent FRET limit.

8. Army and contractor efforts to permanently resolve FRET issues will continue to be unsuccessful without IRS participation in the resolution process.

The Army has made numerous attempts over the years to recognize the disparity between FAR and Command level tax provisions, and the FRET statute these provisions are intended to implement. In many instances, proposed changes have resulted from disagreements between the Army and its contractors that were caused by post-award changes ranging from revisions in the tax statute to contract changes required by the Army to meet mission requirements. Even the most mundane contract revision from the Army's perspective, such as a change in vehicle delivery destination, has caused

significant disagreement between the Army and its contractors, and resulted in protracted and costly litigation.

As a result of these sometimes long-standing disagreements, the Army has taken numerous measures over the years to revise contract language to better define the requirements of the FRET statute and avoid misinterpretation and disagreements with its contractors. In the course of responding to FRET issues, the Army initially took a laissez-faire approach, and relied on the standard FAR tax clause to place sole responsibility for FRET payment directly on its contractors. However, in the course of administering its contracts, the Army came to realize that its need for flexibility in making certain contract changes impacted contractor FRET payments. The result was protracted discussions and disagreements between the contracting parties that led the Army to move gradually from this hands-off approach to one that contractually defined the FRET payment process for both the Army and its contractors, through Command level clauses. The purpose of these clauses was to avoid disagreements during the inevitable contract change process. On several occasions, the Army coordinated these changes with its contractors, as a result of ongoing contract disputes. Although many of these contract clause revisions and mutual agreements between the contracting parties managed to resolve the immediate contract dispute, rarely has an agreement survived the close-out of the contract under which the dispute took place.

In many instances, this lack of any long-term agreement was the result of the competitive Tactical Vehicle market that allowed the Army to contract with several different vehicle manufacturers. Each of these contractors used their own internal and external tax and legal advisors to interpret the FRET statute, and its implication in any

given contracting scenario. In some cases these contractors, or their representatives, had contact with local IRS representatives to assist them in their interpretation of the tax law. Even then, rarely did an agreement between the contracting parties withstand scrutiny on other than the original contract or with the original contractor.

Although defense contractors have had some success in working with the IRS to resolve FRET disputes, the Army has been unable to avail itself of this opportunity, due to IRS statutes and regulations against divulging taxpayer information to third parties. Thus, although the Army pays the tax in the price it pays its contractors, the taxpayer of record is the vehicle manufacturer, not the Army. As such, the IRS has been unwilling to formally assist the contracting parties when disputes arise. However, the evidence is clear that the two parties involved in DOD contracts can not permanently resolve FRET issues by themselves. The lack of IRS participation in the FRET resolution process only serves to add to the administrative burden to both the Army and its contractors as they struggle to address the many tax issues that continue to arise in the DOD contracting environment. IRS participation in the resolution process is imperative if the FRET dispute cycle is ever going to be permanently resolved between the Army and its wheeled vehicle manufacturers.

C. RECOMMENDATIONS

The current cost and administrative burden of FRET payment by DOD on its acquisition of Tactical Wheeled Vehicles is considerable. There are significant direct and indirect costs to both DOD and its defense contractors. Below are recommendations that address the various aspects of the DOD FRET payment process that have been raised in the course of this thesis.

1. Streamline the FRET payment process to reduce the cost to DOD and its contractors.

In many respects FRET is a dichotomy between its simplicity as an excise tax, collected in the price wheeled vehicle manufacturers charge their customers, and its complexity as a form of tax, requiring supporting rationale and documentation in sufficient quantity to alleviate any doubt as to the propriety of the amount paid. Although this might be an overstatement in some instances, FRET is truly a complex issue when it comes to the purchase of wheeled vehicles by DOD. Its impact has been felt at each stage of the acquisition process, and, at its worst, has resulted in the degradation of the contractual relationship between the Army and some of its contractors. As such, allowing the FRET statute to remain unchanged, along with current DOD implementation policies, creates an untenable situation, that begs for continued discord between the contracting parties. Over the last 20 years, the Army has attempted on numerous occasions to clarify and simplify the payment of FRET to its contractors. Most of these changes have failed to have the intended effect of eliminating FRET problems. The result has been millions of dollars in administrative and litigation costs to both the Army and its contractors.

To reduce this burden on both the Army and its contractors, joint efforts must be made to streamline the FRET payment process, by agreeing to implementation and payment procedures prior to entering into contractual agreements. In today's environment of acquisition reform and ALPHA contracting, the contracting parties are encouraged to work together as partners, when fashioning Government requirements and contractual arrangements. This is no less important when it comes to the manner in

which the parties will handle FRET payments and contract changes that impact these payments. The lack of such agreement has resulted in millions of dollars in wasted time and effort in the acquisition process and resulted in significant litigation and settlement costs to DOD.

2. Revise the tax statute to change FRET from an excise tax to a "Use" tax.

Currently, FRET tax is paid by vehicle manufacturers based on the selling price of their products. As a result, buyers of higher priced vehicles that may not use the Federal highway system pay a disproportionate amount of tax. Under the current law, DOD pays an unfair share of taxes into the Highway Trust Fund, because it purchases expensive vehicles that use the Federal highway system only 35 percent of their operating life. A "Use" tax would better distribute the tax burden on a relational basis to actual Federal highway usage, and save less frequent highway users millions of dollars in tax payments. Although there is no question that this would benefit the Army, by more equitably distributing the FRET burden, such a change would also address the issue of the fair allocation of the tax burden by levying the tax on a proportionate basis to commercial truck purchasers, as well.

Implementing this change in the tax statutes would most likely require the support of the Department of the Treasury, as well as Congress. This would also require considerable support from the Trucking industry, to which the impact would be most seriously felt. However, based on the inherent fairness of such a tax, it would seem likely that a constituency could be built around such a proposal. Should such a change occur, the impact to DOD would be a significant reduction in its tax burden.

3. Eliminate the administrative burden by revising the method of FRET payment for DOD.

The cost of FRET to DOD can be separated into two distinct categories, direct and indirect. The direct cost of the tax is the 12 percent that DOD includes in the price it must pay its contractors in the acquisition of its Medium and Heavy Tactical Wheeled Vehicle fleet. The indirect cost results from the administrative burden placed on DOD procurement commands in the course of managing solicitations and contracts for vehicles requiring the payment of FRET. Although not as high as the direct cost of the tax, history has shown that the indirect cost impact is considerable. Thus, as a result of the flexibility required by the contracting commands in the management and administration of their contracts, the FRET tax is not as benign as it might appear. In fact, in addition to the direct cost, which must be recalculated with every change in the vehicle price, considerable administrative effort is required to assure the Army is paying its contractors the correct amount of FRET. This administrative burden also applies to Army contractors who must keep detailed tax records in anticipation of both IRS and DOD audit requirements, the resultant cost of which is passed on to the Army in the price of vehicles.

One manner of reducing or eliminating this indirect cost burden to DOD and its contractors, is to develop a more streamlined method of tax payment that minimizes the need for detailed record-keeping, and decreases FRET problems between the contracting parties. A method of implementing this recommendation would be for Congress to appropriate, or OMB to apportion 12 percent of the DOD Medium and Heavy Tactical

Wheeled Vehicle budget directly to the Department of the Treasury to cover DOD's FRET liability before it actually procures the vehicles. This recommendation would likely require a change to the current tax statute, exempting defense contractors from the payment of FRET on vehicles sold to DOD, since DOD would be paying the tax directly to the IRS on their behalf. In essence, DOD would become the taxpayer of record, and FRET issues could be addressed directly between DOD and the IRS, thereby eliminating the current issues that are caused by DOD changes to its tactical vehicle contracts. The indirect cost savings in taking this approach would be significant, and would result in an increase in buying power when replacing the current Tactical Wheeled Vehicle fleet.

4. Exempt DOD from the payment of FRET in the purchase of its Tactical Wheeled Vehicles.

Under the current statute, the Secretary of the Treasury has authority to exempt certain vehicles from the payment of FRET. The Secretary has exercised this authority for many vehicles that make limited use of the Federal highway system. The Secretary should use this authority to exempt Tactical Wheeled Vehicles sold to DOD. A review of the data indicates that such an exemption would not have a significant impact on the Federal Highway Trust Fund, as the DOD contribution, through its contractors, is relatively small. In addition, from a holistic perspective, the impact to the HTF would be offset by the reduced administrative burden to DOD and its contractors.

D. ANSWERS TO RESEARCH QUESTIONS

The following primary and subsidiary research questions were addressed in the course of this study. Each question and a brief answer are provided below.

1. What is the cost to the Government, both monetary and otherwise, of the Army (Department of Defense) paying Federal Retail Excise Tax (FRET) to the IRS (Department of Treasury), through third party defense contractors?

The data show that DOD, through its primary wheeled vehicle purchaser, the Army, paid more than half a billion dollars between 1981 and 1995 to its wheeled vehicle contractors to cover the cost of FRET. The Army continues to pay this tax on all wheeled vehicles it purchases, that meet the weight limits stated in the FRET statute, and projections indicate that it will pay over $150 million between 1999 and 2005 on its Medium Truck fleet, alone. In addition to the direct cost of the tax, the Army and its contractors pay a tremendous amount in the form of indirect costs to administer the FRET payment process, and resolve FRET issues that arise on the Army's Tactical Vehicle programs. These indirect costs include lost opportunity costs, record keeping costs, contract management costs, investigation and audit costs, solicitation preparation and proposal costs, and negotiation and litigation costs.

2. What is FRET and what is the Army policy regarding payment of FRET to its defense contractors?

FRET is a Federal excise tax that is represented in the United States Code as Title 26, Section 4051, entitled, "Imposition of Tax on Heavy Trucks and Trailers Sold at Retail." It imposes a 12 percent tax on the first retail sale of truck chassis and bodies exceeding 33,000 pounds GVW and truck trailer and semitrailer chassis and bodies exceeding 26,0000 pounds GVW. Said tax applies to the Army's Medium and Heavy Tactical Vehicle fleet, as these vehicles meet the description of vehicles, as stated in the statute. Although it has changed over the years, as the Army has addressed many

problems with FRET between itself and its contractors, the Army's policy on FRET is to follow the guidance provided in the Federal Acquisition Regulation, as supplemented by Command level clauses to assure the fair and accurate payment of FRET to its contractors, and by its contractors to the IRS.

3. How do defense contractors administer the payment of FRET to the IRS?

Defense contractors collect FRET in the unit price of vehicles sold to the Army and the other Military Services. Once collected, contractors make periodic tax payments to the IRS in accordance with agreed upon payment schedules. In addition, both the IRS and DOD conduct periodic audits to assure the proper amount of FRET is remitted to the IRS. In order to avoid errors in the payment of the tax, and to address issues that commonly occur between the contractor, the Army, and the IRS; contractors keep comprehensive records on the amount of FRET payments received from DOD and paid to the IRS.

4. How does the FRET statute determine the manner of tax payment, and to what extent does this cause an administrative burden to the Army, the defense contractor, or both?

The statute requires FRET to be included in the price of vehicles meeting FRET requirements and sold by vehicle manufacturers. The amount of the tax is 12 percent. However, the statute exempts certain vehicle components, as they have separate tax requirements. For example, the tax code provides guidance on how to calculate FRET for tires separately from other vehicle components. Thus, to calculate vehicle FRET correctly, a manufacturer must separate out the cost of the tires, calculate the cost of the vehicle (less tires) for FRET purposes, separately calculate the tire FRET, and then add

the tire FRET to the vehicle FRET to obtain a total FRET figure. The complexity of the tax itself often results in differing interpretations of the way the tax should be applied to the price of vehicles. These interpretation differences often result in disputes between the Army and its contractors. In addition, contract changes required by the Army in the course of providing vehicles to soldiers in the field exacerbate the interpretation differences and often magnify the disputes between the parties. As a result of these disagreements and disputes, various monitoring and accounting mechanisms have been put in place by both the Army and its contractors, resulting in a significant administrative burden to both.

5. To what extent should the Army change its policy regarding FRET?

As a result of FRET problems that have arisen between the Army and its contractors over the last 20 years, the Army has made numerous attempts to revise its FRET policies in an effort to reduce the amount of misinterpretation and discord between it and its contractors. These policy changes have ranged from providing solicitation guidance concerning FRET to its contractors, to implementing Command level tax provisions to explain the Army's interpretation of the FRET statute. Despite these efforts, FRET issues continue to arise on Tactical Vehicle contracts. As a result, the Army should consider working cooperatively with its wheeled vehicle manufacturers in attempting any future policy changes.

6. Should the FRET statute apply to DOD customers, and is there a more efficient manner of determining the amount of the tax burden, and ultimately collecting this tax?

The question of applicability depends on one's perspective. Considering that FRET funds the Federal Highway Trust Fund, any vehicle that uses the nation's highways should be required to pay its fair share. However, as a result of the manner in which it is collected today, DOD pays a disproportionate share of the tax burden. In fact, DOD vehicles make minimal use of the Federal highways as compared to commercial truck purchasers. As a result of the significant administrative burden placed upon DOD and its contractors to collect the tax, an argument can be made that the DOD contribution to the Highway Trust Fund is small, when compared to the cost of collecting the tax. DOD should, therefore, be exempt from payment.

However, if the tax were based on usage of the Federal highways, a more equitable tax burden would be placed on DOD, as well as the commercial trucking industry, and a better argument could be made for the applicability of FRET to DOD.

7. What actions should be taken regarding statutory and regulatory language to modify the application of FRET?

From a regulatory standpoint, the Secretary of the Treasury should review the appropriateness of DOD paying FRET in the purchase of its Medium and Heavy Tactical Wheeled Vehicles, to determine the propriety of using the authority granted him in the statute to exempt vehicles purchased by DOD for military use.

From a statutory standpoint, Congress should review the actions of the Secretary of the Treasury in this regard, to determine whether DOD should be exempted from FRET payment on vehicles purchased for military use, within the statute itself. Separately, Congress should review the current statute to assess whether the manner in which FRET is currently collected in the form of an excise tax is appropriate, or whether a more equitable collection process could be implemented in the form of a "Use" tax.

E. SUGGESTIONS FOR FURTHER RESEARCH

1. Possible streamlining actions to simplify the FRET payment process for the Army and its contractors.

2. Possible FRET exemption request from DOD to the Secretary of the Treasury.

3. Legislative package requesting a review of the appropriateness of DOD payment of FRET.

4. Investigation into the effectiveness of an Excise tax versus a Use tax.

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APPENDIX A. ACRONYMS AND ABBREVIATIONS

ADR	Alternate Dispute Resolution
AMG	AM General Corporation
ARVECO	Army Vehicle Company (Precursor to BMY on M939A2 program)
ASBCA	Armed Services Board of Contract Appeals
CARC	Chemical Agent Resistant Coating
CICA	Competition in Contracting Act of 1984
CID	Criminal Investigation Division (Department of Defense)
CLIN	Contract Line Item Number
CONUS	Continental United States
CTIS	Central Tire Inflation System
DCAA	Defense Contract Audit Agency
DCMAO	Defense Contract Management Area Operations
DD250	Department of Defense Acceptance Document
DOD	Department of Defense
DOT	Department of Transportation
ECP	Engineering Change Proposal
EPA	Environmental Protection Agency
FA	Formal Advertising
FAR	Federal Acquisition Regulation
FAT	First Article Testing
FET	Federal Excise Tax (the precursor to FRET)
FHWA	Federal Highway Administration
FMS	Foreign Military Sales
FMTV	Family of Medium Tactical Vehicles (2 ½ & 5 Ton Trucks)
FMVSS	Federal Motor Vehicle Safety Standards

FRET	Federal Retail Excise Tax
FTL	Freightliner Corporation
FY	Fiscal Year
GAO	General Accounting Office
GSA	General Services Administration
GVW	Gross Vehicle Weight
HEMTT	Heavy Expanded Mobility Tactical Truck (10 T family of vehicles)
HET	Heavy Equipment Transporter (Tractor/Trailer Tank Hauler)
HTF	Federal Highway Trust Fund
IRS	Internal Revenue Service
LVS	Logistics Vehicle System (Marine Corps version of the HEMTT)
M915/M916	Line Haul Tractor Family (designed to haul 15-20 Tons)
MOA	Memorandum of Agreement
MSC	Major Subordinate Command
NDI	Non-developmental Item
OCONUS	Outside the Continental United States
OMB	Office of Management and Budget
OTC	Oshkosh Truck Corporation
PARC	Principal Assistant Responsible for Contracting
PCAP	Pilot Contracting Activities Program (PL 98-191, 1988)
PCO	Procuring Contracting Officer
POM	Program Objective Memorandum
PPBS	Planning, Programming, and Budgeting System

REA	Request for Equitable Adjustment
S&S	Stewart & Stevenson Services, Incorporated
SSA	Source Selection Authority
SSAC	Source Selection Advisory Council
SSEB	Source Selection Evaluation Board
TACOM	US Army Tank-automotive and Armaments Command
TWV	Tactical Wheeled Vehicle
US	United States of America
USMC	United States Marine Corps

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APPENDIX B. ADDITIONAL SOURCE DATA

1. The Competition in Contracting Act (CICA) of 1984, although continuing to express a preference for DOD to procure its items through competitive means, gave DOD the opportunity to use Competitive Negotiation methods in addition to Formal Advertising, in its competitive procurements.

2. The Army procurement official who verbally relayed this information to the bidder was the author, who was the senior contract specialist on the program at the time.

3. Extensive discussions over this issue took place between the author, the legal advisor, Mr. Ronald Goldstone, who has since retired, and the PCO, Mr. Dick Sheill, who is also retired. The consensus was that the other bidders, by their lack of inquiry were as unaware as these Army procurement officials were about the expiration of the law, and this was the most prudent course of action.

4. The Army evaluation was made more difficult because the second low bidder, AM General Corporation, the then current producer, had "disguised" its bid by providing FRET and non-FRET prices that were only a couple of hundred dollars apart for all vehicle configurations. These price differences were several thousand dollars per vehicle less than what the 12% FRET calculation would indicate was appropriate.

5. Based on numerous discussions between Army procurement and legal officials from 1987 to 1992, Mr. John Klecha, TACOM procurement legal advisor, wrote a Discussion Briefing Paper, which summarized FRET issues.

6. Due to the recent nature of this acquisition and competition sensitivity, the Government evaluator requested anonymity when offering this information.

7. Although the Army is not the only service that uses Tactical Wheeled Vehicles to support its mission, it is the largest military user of these vehicles, and purchases these vehicles for all other military services. The Army does not include other military tactical vehicle fleets in its Fleet Planning Documents. The Army has the vast preponderance of these vehicles within DOD.

8. Not all vehicles and models within the Medium and Heavy Truck and Trailer fleet are subject to FRET. Only vehicles exceeding 33,000 pounds GVW for trucks and 26,000 pounds GVW for trailers, and not exempted from the tax payment due to an IRS ruling, are subject to the tax. The preponderance of the vehicles in the fleet are subject to the tax.

9. The Army usually writes its vehicle contracts as "FOB Origin," it is therefore responsible for transportation from the manufacturer's production facility. Contractors are not responsible for vehicles once accepted for shipment by the Government. If vehicles are then diverted "in-route," actual vehicle destinations may not match contract documents.

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APPENDIX C. UNITED STATES CODE (USC 26, SEC 4051)

Title 26, Internal Revenue Code

Sec. 4051. Imposition of tax on heavy trucks and trailers sold at retail

- (a) Imposition of tax
  - (1) In general
    There is hereby imposed on the first retail sale of the following articles (including in each case parts or accessories sold on or in connection therewith or with the sale thereof) a tax of 12 percent of the amount for which the article is so sold:
    - (A) Automobile truck chassis.
    - (B) Automobile truck bodies.
    - (C) Truck trailer and semitrailer chassis.
    - (D) Truck trailer and semitrailer bodies.
    - (E) Tractors of the kind chiefly used for highway transportation in combination with a trailer or semitrailer.
  - (2) Exclusion for trucks weighing 33,000 pounds or less
    The tax imposed by paragraph (1) shall not apply to automobile truck chassis and automobile truck bodies, suitable for use with a vehicle which has a gross vehicle weight of 33,000 pounds or less (as determined under regulations prescribed by the Secretary).
  - (3) Exclusion for trailers weighing 26,000 pounds or less
    The tax imposed by paragraph (1) shall not apply to truck trailer and semitrailer chassis and bodies, suitable for use with a trailer or semitrailer which has a gross vehicle weight of 26,000 pounds or less (as determined under regulations prescribed by the Secretary. [1]
  - (4) Sale of trucks, etc., treated as sale of chassis and body
    For purposes of this subsection, a sale of an automobile truck or truck trailer or semitrailer shall be considered to be a sale of a chassis and of a body described in paragraph (1).
- (b) Separate purchase of truck or trailer and parts and accessories therefore
  Under regulations prescribed by the Secretary -
  - (1) In general
    If -

        - (A) the owner, lessee, or operator of any vehicle which contains an article taxable under subsection (a) installs (or causes to be installed) any part or accessory on such vehicle, and
          (B) such installation is not later than the date 6 months after the date such vehicle (as it contains such article) was first placed in service,
          then there is hereby imposed on such installation a tax equal to 12 percent of the price of such part or accessory and its installation.

    - (2) Exceptions
      Paragraph (1) shall not apply if -

        - (A) the part or accessory installed is a replacement part or accessory, or

        - (B) the aggregate price of the parts and accessories (and their installation) described in paragraph (1) with respect to any vehicle does not exceed $1,000 (or such other amount or amounts as the Secretary may by regulations prescribe).

    - (3) Installers secondarily liable for tax
      The owners of the trade or business installing the parts or accessories shall be secondarily liable for the tax imposed by paragraph (1).

- (c) Termination
  On and after October 1, 2005, the taxes imposed by this section shall not apply.

- (d) Credit against tax for tire tax
  If -

    - (1) tires are sold on or in connection with the sale of any article, and
      (2) tax is imposed by this subchapter on the sale of such tires, there shall be allowed as a credit against the tax imposed by this subchapter an amount equal to the tax (if any) imposed by section 4071 on such tires.

Footnotes

[1] So in original. Probably should be preceded by a closing parenthesis.

APPENDIX D. FAR PART 29, TAXES, SUBPART 29.2, FEDERAL EXCISE TAXES

29.201 -- General.

(a) Federal excise taxes are levied on the sale or use of particular supplies or services. Subtitle D of the Internal Revenue Code of 1954, Miscellaneous Excise Taxes, 26 U.S.C.4041, *et seq.*, and its implementing regulations, 26 CFR 40 through 299, cover miscellaneous federal excise tax requirements. Questions arising in this area should be directed to the agency-designated counsel. The most common excise taxes are--

(1) Manufacturers' excise taxes imposed on certain motor-vehicle articles, tires and inner tubes, gasoline, lubricating oils, coal, fishing equipment, firearms, shells, and cartridges sold by manufacturers, producers, or importers; and

(2) Special-fuels excise taxes imposed at the retail level on diesel fuel and special motor fuels.

(b) Sometimes the law exempts the Federal Government from these taxes. Contracting officers should solicit prices on a tax-exclusive basis when it is known that the Government is exempt from these taxes, and on a tax-inclusive basis when no exemption exists.

(c) Executive agencies shall take maximum advantage of available Federal excise tax exemptions.

29.202 -- General Exemptions.

No Federal manufacturers' or special-fuels excise taxes are imposed in many contracting situations as, for example, when the supplies are for any of the following:

(a) The exclusive use of any State or political subdivision, including the District of Columbia (26 U.S.C.4041 and 4221).

(b) Shipment to a United States possession or Puerto Rico, or for export. Shipment or export must occur within 6 months of the time title passes to the Government. When the exemption is claimed, the words "for export or shipment to a possession" must appear on the contract or purchase document, and the contracting officer must furnish the seller proof of export (see 26 CFR 48.4221-3).

(c) Further manufacture, or resale for further manufacture (this exemption does not include tires and inner tubes) (26 CFR 48.4221-2).

(d) Use as fuel supplies, ships or sea stores, or legitimate equipment on vessels of war, including

(1) aircraft owned by the United States and constituting a part of the armed forces and

(2) guided missiles and pilotless aircraft owned or chartered by the United States. When this exemption is to be claimed, the purchase should be made on a tax-exclusive basis. The contracting officer shall furnish the seller an exemption certificate for Supplies for Vessels of War (an example is given in 26 CFR 48.4221-4(d)(2); the IRS will accept one certificate covering all orders under a single contract for a specified period of up to 12 calendar quarters) (26 U.S.C.4041 and 4221).

(e) A nonprofit educational organization (26 U.S.C.4041 and 4221).

(f) Emergency vehicles (26 U.S.C.4053 and 4064(b)(1)(c)).

29.203 -- Other Federal Tax Exemptions.

(a) Pursuant to 26 U.S.C.4293, the Secretary of the Treasury has exempted the United States from the communications excise tax imposed in 26 U.S.C.4251, when the supplies and services are for the exclusive use of the United States. (Secretarial Authorization, June 20, 1947, Internal Revenue Cumulative Bulletin, 1947-1, 205.)

(b) Pursuant to 26 U.S.C.4483(b), the Secretary of the Treasury has exempted the United States from the federal highway vehicle users tax imposed in 26 U.S.C.4481. The exemption applies whether the vehicle is owned or leased by the United States. (Secretarial Authorization, Internal Revenue Cumulative Bulletin, 1956-2, 1369.)

29.401-3 -- Competitive Contracts.

The contracting officer shall insert the clause at 52.229-3, Federal, State, and Local Taxes, in solicitations and contracts if the contract is to be performed wholly or partly within the United States, its possessions, or Puerto Rico, when a fixed-price contract is contemplated and the contract is expected to exceed the simplified acquisition threshold, unless the clause at 52.229-4, Federal State, and Local Taxes (Noncompetitive Contract), is included in the contract.

29.401-4 -- Noncompetitive Contracts.

The contracting officer shall insert the clause at **52.229-4**, Federal, State, and Local Taxes (Noncompetitive Contract), in fixed-price noncompetitive contracts when the contract exceeds the simplified acquisition threshold, to be performed wholly or partly within the United States, its possessions, or Puerto Rico when satisfied that the contract price does not include contingencies for State and local taxes, and that, unless the clause is used, the contract price will include such contingencies.

APPENDIX E. FAR SUBPARTS 52.229-3 AND 4, FEDERAL, STATE, AND LOCAL TAXES (CONTRACT CLAUSES)

52.229-3 -- Federal, State, and Local Taxes (Jan 1991)

As prescribed in 29.401-3, insert the following clause:

Federal, State, and Local Taxes (Jan 1991)

(a) *"Contract date,"* as used in this clause, means the date set for bid opening or, if this is a negotiated contract or a modification, the effective date of this contract or modification.

"All applicable Federal, State, and local taxes and duties," as used in this clause, means all taxes and duties, in effect on the contract date, that the taxing authority is imposing and collecting on the transactions or property covered by this contract.

"After-imposed Federal tax," as used in this clause, means any new or increased Federal excise tax or duty, or tax that was exempted or excluded on the contract date but whose exemption was later revoked or reduced during the contract period, on the transactions or property covered by this contract that the Contractor is required to pay or bear as the result of legislative, judicial, or administrative action taking effect after the contract date. It does not include social security tax or other employment taxes.

"After-relieved Federal tax," as used in this clause, means any amount of Federal excise tax or duty, except social security or other employment taxes, that would otherwise have been payable on the transactions or property covered by this contract, but which the Contractor is not required to pay or bear, or for which the Contractor obtains a refund or drawback, as the result of legislative, judicial, or administrative action taking effect after the contract date.

(b) The contract price includes all applicable Federal, State, and local taxes and duties.

(c) The contract price shall be increased by the amount of any after-imposed Federal tax, provided the Contractor warrants in writing that no amount for such newly imposed Federal excise tax or duty or rate increase was included in the contract price, as a contingency reserve or otherwise.

(d) The contract price shall be decreased by the amount of any after-relieved Federal tax.

(e) The contract price shall be decreased by the amount of any Federal excise tax or duty, except social security or other employment taxes, that the Contractor is required to pay or bear, or does not obtain a refund of, through the Contractor's fault, negligence, or failure to follow instructions of the Contracting Officer.

(f) No adjustment shall be made in the contract price under this clause unless the amount of the adjustment exceeds $250.

(g) The Contractor shall promptly notify the Contracting Officer of all matters relating to any Federal excise tax or duty that reasonably may be expected to result in either an increase or decrease in the contract price and shall take appropriate action as the Contracting Officer directs.

(h) The Government shall, without liability, furnish evidence appropriate to establish exemption from any Federal, State, or local tax when the Contractor requests such evidence and a reasonable basis exists to sustain the exemption.

52.229-4 -- Federal, State, and Local Taxes (Noncompetitive Contract) (Jan 1991)

As prescribed in 29.401-4, insert the following clause:

Federal, State, and Local Taxes (Noncompetitive Contract (Jan 1991)

(a) *"Contract date,"* as used in this clause, means the effective date of this contract and, for any modification to this contract, the effective date of the modification.

"All applicable Federal, State, and local taxes and duties," as used in this clause, means all taxes and duties, in effect on the contract date, that the taxing authority is imposing and collecting on the transactions or property covered by this contract.

"After-imposed tax," as used in this clause, means any new or increased Federal, State, or local tax or duty, or tax that was excluded on the contract date but whose exclusion was later revoked or amount of exemption reduced during the contract period, other than an excepted tax, on the transactions or property covered by this contract that the Contractor is required to pay or bear as the result of legislative, judicial, or administrative action taking effect after the contract date.

"After-relieved tax," as used in this clause, means any amount of Federal, State, or local tax or duty, other than an excepted tax, that would otherwise have been payable on the transactions or property covered by this contract, but which the Contractor is not required to pay or bear, or for which the Contractor obtains a refund or drawback, as the result of legislative, judicial, or administrative action taking effect after the contract date.

"Excepted tax," as used in this clause, means social security or other employment taxes, net income and franchise taxes, excess profits taxes, capital stock taxes, transportation taxes, unemployment compensation taxes, and property taxes. "Excepted tax" does not include gross income taxes levied on or measured by sales or receipts from sales, property taxes

assessed on completed supplies covered by this contract, or any tax assessed on the Contractor's possession of, interest in, or use of property, title to which is in the Government.

(b) Unless otherwise provided in this contract, the contract price includes all applicable Federal, State, and local taxes and duties.

(c) The contract price shall be increased by the amount of any after-imposed tax, or of any tax or duty specifically excluded from the contract price by a term or condition of this contract that the Contractor is required to pay or bear, including any interest or penalty, if the Contractor states in writing that the contract price does not include any contingency for such tax and if liability for such tax, interest, or penalty was not incurred through the Contractor's fault, negligence, or failure to follow instructions of the Contracting Officer.

(d) The contract price shall be decreased by the amount of any after-relieved tax. The Government shall be entitled to interest received by the Contractor incident to a refund of taxes to the extent that such interest was earned after the Contractor was paid by the Government for such taxes. The Government shall be entitled to repayment of any penalty refunded to the Contractor to the extent that the penalty was paid by the Government.

(e) The contract price shall be decreased by the amount of any Federal, State, or local tax, other than an excepted tax, that was included in the contract price and that the Contractor is required to pay or bear, or does not obtain a refund of, through the Contractor's fault, negligence, or failure to follow instructions of the Contracting Officer.

(f) No adjustment shall be made in the contract price under this clause unless the amount of the adjustment exceeds $250.

(g) The Contractor shall promptly notify the Contracting Officer of all matters relating to Federal, State, and local taxes and duties that reasonably may be expected to result in either an increase or decrease in the contract price and shall take appropriate action as the Contracting Officer directs. The contract price shall be equitably adjusted to cover the costs of action taken by the Contractor at the direction of the Contracting Officer, including any interest, penalty, and reasonable attorneys' fees.

(h) The Government shall furnish evidence appropriate to establish exemption from any Federal, State, or local tax when --

(1) The Contractor requests such exemption and states in writing that it applies to a tax excluded from the contract price; and

(2) A reasonable basis exists to sustain the exemption.

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APPENDIX F. TACOM COMMAND LEVEL TAX CLAUSES

52.229-4003 (TACOM)

(a) Because the final destination for all vehicles to be furnished under this contract may not be known at time of contract award, the final number of vehicles that will be fielded outside the continental United States may also be unknown. The destinations cited in the solicitation are for evaluation purposes only, and may not represent the final contractual quantity to be shipped within the United States. (See FAR Subpart 25.101 and FAR Subpart 29.202 (b).)

(b) Notwithstanding the above, the Contractor must submit a fixed price for vehicles to be furnished under this contract which, pursuant to FAR 52.229-3 FEDERAL, STATE, AND LOCAL TAXES or FAR 52.229-4 FEDERAL, STATE, AND LOCAL TAXES (NONCOMPETITIVE CONTRACT), includes all applicable federal, state, and local taxes, including Federal Retailers Excise Tax (FRET). FRET applies to vehicles furnished under this contract that will be shipped to destinations within the United States, but will not apply to vehicles exported outside the United States within six months of the date of final acceptance by the Government. Should tax be paid on any vehicles, which are subsequently exported by the Government prior to first use, the Contractor has a duty to pursue a refund, upon notice of such export by the Government, if such notice is provided any time within three years of final acceptance.

(c) The Contractor is required to identify in the Schedule (Section B) of this contract the total dollar amount included in the unit price of each vehicle that represents the Contractor's FRET liability for such vehicles(s), to be shipped to destinations within the United States.

(d) It is understood and agreed that in the event that vehicles originally expected to be fielded within the United States are eventually shipped for export outside the United States prior to use or further manufacture, or if vehicles originally expected to be shipped for export outside the United States (and whose unit prices contain no amount for FRET) are later shipped for fielding within the United States, this contract will be modified to make the appropriate adjustment in the unit price of such vehicles to reflect the Contractor's actual FRET obligation. Such adjustment shall be calculated based upon (i) the information set forth in Sections B, H, and K of this contract, if the Contractor has provided such information; or, if not, (ii) the formula set forth in paragraph (e) below, and the unit price(s) set forth in Section B of this contract.

(e) Federal Retailers Excise Tax is computed pursuant to 26 USC 4051, 4052, and 4216 and related Internal Revenue Regulations. The basic computational formula is as follows:

(a) Retail Sale Price of Vehicle (Total price excluding FRET)	$ XX,XXX
(b) Federal Retailers Excise Tax Liability (a times 0.12)	X,XXX
(c) Less: Tire and Other FRET	-X,XXX

(g) TOTAL PRICE for FRET-Applicable Vehicles (a plus b minus c) $ XX,XXX

NOTE 1: The amount inserted on line (a) above, is the total sales price exclusive of FRET. Internal Revenue Regulation 48.4216 makes it clear that the Federal Retailers Excise Tax is NOT part of the sales price but rather, is an amount added to the sales price to arrive at a tax-inclusive amount. If you are asked to give a price on a vehicle without FRET, this amount (line a) should correspond with your without-FRET bid or proposed price.

NOTE 2: The net FRET amount remaining after subtracting line (c) above from line (b) above is the amount to be inserted in the space provided in Section B, CONTRACTOR IDENTIFICATION OF AMOUNT OF FEDERAL RETAILERS EXCISE TAX PER VEHICLE, for each vehicle CLIN of this solicitation.

(f) If the Contractor determines before bid opening (sealed bids) or contract award (RFPs) that FRET is inapplicable to vehicles to be fielded within the United States, the Contractor shall immediately furnish written evidence in support of this determination, to include a photocopy of the IRS ruling, to the Procuring Contracting Officer (PCO). The Contractor must ensure that any evidence submitted applies to the current acquisition and bears the risk if such written evidence is later determined to be inapplicable by the IRS.

(g) It is understood and agreed that pursuant to paragraph (g) of both FAR 52.229-3 and FAR 52.229-4, the Contractor agrees to petition the IRS for private rulings to clarify tax applicability, if requested to do so by the Contracting Officer.

(h) The requirements of this clause are in addition to, and not in limitation of, any other requirements of law or of this contract. Amounts provided by the Contractor regarding included Federal Retailers Excise Tax may be utilized by the Government to facilitate any adjustments in addition to changes in destination, regarding Contractor liability for Federal Retailers Excise Tax.

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52.229-4004 (TACOM)

(a) The purpose of this clause is to prescribe procedures for Contractor representation of net Federal Retailers Excise Tax (FRET) adjustments required to be made to the contract price as a result of after-imposed Federal Tax or after-relieved Federal Tax as those terms are defined in the clause, FEDERAL, STATE, AND LOCAL TAXES, located in Section 4 of this contract.

(b) As detailed in subparagraphs (c)-(d) of this clause, the Contractor shall notify the Procuring Contracting Officer (PCO) promptly of all matters relating to FRET which may reasonably be expected to require an increase or decrease in the contract price in excess of $100.

(c) Within 120 days after a change in FRET liability for contracted items calls for an adjustment in the contract price (or such greater period of time as the parties may mutually agree upon) the Contractor shall forward a statement as specified in DOD FAR Supplement 52.233-7000 signed by a representative with binding contractual authority which states the following for each supply-item CLIN:

(1) The detailed tax basis and method of calculation for federal retailers excise tax for the former liability amount and the adjusted FRET liability amount due to an after-imposed or after-relieved tax.

(2) The amount previously included in the contract price for FRET liability and a warrant in writing that an amount for a newly imposed federal excise retailers tax or rate increase was not included in the contract price as a contingency reserve or otherwise.

(3) The amount paid by the Contractor to the IRS for FRET (plus interest and penalty as applicable) for each contract CLIN supply item which is subject to a FRET change, and any and all amounts refunded by the IRS (plus interest and penalty amounts as applicable). Net adjustments to the IRS should clearly reflect the debits and credits included in the overall calculations.

(4) The Contractor's statement shall be submitted with sufficient supporting evidence to permit the Government to verify the accuracy of the statement through audit review as expressed in the contract clause entitled AUDIT in Section I of the contract. The supporting evidence shall conform to generally accepted accounting principles and practices, inclusive of compliance with applicable Cost Accounting Standards.

(d) All FRET adjustments (inclusive of interest and penalty amounts when applicable) which are to be credited to the Government under the terms of the contract's FEDERAL, STATE, AND LOCAL TAXES clause shall bear interest at the rate stated in the FAR 52.232-17 INTEREST clause commencing thirty days after receipt by the Contractor from the IRS.

(e) The requirements of this clause are in addition to, and not in limitation of, the requirements of any other contract clause.

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